

INVESTMENT BANKING IN ENGLAND

BY

BRADLEY D. NASH

PRIZE MONOGRAPH

CHICAGO TRUST COMPANY PRIZES FOR RESEARCH RELATING TO
BUSINESS DEVELOPMENT AND THE MODERN TRUST COMPANY
(1924 AWARD—FIRST PRIZE)



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FOREWORD

Investment Banking in England, by Bradley D. Nash, received the first prize for monographs in the field of Business Development and the Modern Trust Company, offered in 1923 by the Chicago Trust Company. *The Investment Trust*, by Lawrence M. Speaker, was awarded second prize. It is published as a companion volume to the present one.

The donor of these prizes challenges the group of practitioners and students in the financial-legal field to a more complete analysis of trust and investment practice, in meeting the financial requirements of individuals and of corporations. A number of questions and problems relating to the trust phases of business have grown up, largely as a result of developments in taxation, in investment practice, in estate management, and in business psychology.

The prizes are intended primarily to stimulate research regarding these problems. They are offered for the best studies on those trust phases of business which constitute the distinctive feature of trust company operations, or on related subjects in the field of private finance. Awards of \$300 and of \$200 are made annually. A triennial research prize of \$2,500 will be awarded in 1926.

The trust company has developed, in the main, through the evolution of the modern corporation.

With the growth of large-scale industry and of agencies to supply the requirements of the saving and investing public, has come "the department store of finance," the modern trust company. Approximately 2,500 trust companies are listed in a current directory, more than half of the number having been established since the beginning of the present era of corporate expansion, shortly before 1900. During this period the bank that is offering these prizes, a typical trust company of middle size, has attained its growth.

The present study and the one by Mr. Speaker were selected from among 18 which were submitted in competition by contestants living in 12 states. These studies, it is thought, will prove of interest in academic circles and to the members of staffs of commercial banks and trust companies, as also to attorneys, to investment bankers, to representatives of insurance companies, and to others engaged in financial or legal work.

Subjects proposed for future research and the rules adhered to in making awards are given in an announcement which will be sent on request by the Secretary of the Committee of Award, Professor Leverett S. Lyon, Dean of the School of Commerce and Finance, Washington University, St. Louis, Missouri.

RALPH E. HEILMAN

PREFACE

THE purpose of this study is to give an account of the machinery and methods by which the surplus funds of the British are collected and turned over to the governments of nations and cities, and to transportation, manufacturing, and commercial companies for their use in permanent or very long time improvements in their equipments.

Before this machinery may be examined, it is necessary to define investment banking, briefly, to show the growth and extent of British investing, and to describe the great market now existing for the exchange of securities. Most of the subjects are covered by excellent books, a list of which is included. Investment trusts, as more or less hybrid types of organization which function in several capacities, are treated in the next to the last chapter.

Prepared material on the subject under discussion is very meager and it was necessary to secure almost all data from original sources. The most fruitful sources of information were conversations with a number of London bankers, who were most generous with their time and experiences and were truly invaluable in the preparation of this thesis. To them and to many Boston bankers I wish to offer my thanks for the information and assistance given me.

BRADLEY D. NASH

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..... III

INVESTMENT BANKING
IN ENGLAND

I

THE DEFINITION OF INVESTMENT BANKING

The function of investment banking. Its essence—turning collected sums into permanent goods. Forms of securities. The profit of investment banking. Its importance in modern days. Subsidiary functions of investment bankers.

THE function of investment banking is to gather together the savings and surplus capital of individuals and companies and to turn this accumulation into the hands of others for use in the construction of fixed plants. From small and large surplus sums a large total is secured with which are constructed new factories, new machinery, railroads, bridges, or, in fact, any permanent equipment which has for a purpose the production of finished goods for the consumer. This production of finished goods for the consumer may be the construction of parks, the product of which is enjoyment and recreation for the public; it may be the building of steamships and other means for furnishing transportation; or it may be the great plants that turn out manufactures of every kind.

The essence of investment banking is that it turns collected sums into permanent goods. It brings together those who have spare funds and those who need funds. It effects an adjustment of resources to needs.

There are some exceptions to the rule. Governments, large and small, may need capital in emergencies for other than permanent purposes; for example, for the recruiting and paying of large armies in times of war. But, on the whole, the purpose is to collect and put in usable form capital needed for extensions of equipment in present undertakings or for fitting up entirely new undertakings.

In order to put the funds of possessors of capital in a convenient form, borrowers have hit upon the scheme of securities of a fixed denomination representing a share in the property or profits of the borrower. These securities are in many forms, ranging from bonds representing a claim upon the plant, machinery, or other fixed assets of the borrower, to ordinary shares representing a right to participate in the profits of a company after the rights of other security-holders have been taken care of.

The investment bankers examine the affairs of governments or companies that come to them for funds and, if satisfied, they will take the securities of the borrower and attempt to distribute them among the public or such members of the public as have surplus funds to lend.

The profit of investment banking arises from the difference between the price which the bankers pay to the borrower for his securities and the price which the bankers can get from the lender.

It must not be imagined that all the acts of purchasing and distributing the securities, of finding capi-

tal and turning it over to the needy parties are accomplished by one banker. On the contrary, there is a considerable division of labor in the work—a decided specialization among many types of houses—but that will be discussed later.

This is but a brief discussion of the purpose of investment banking. It must be remembered that investment banking is but the “handmaid of industry” and that if investment bankers did not exist, those in need of capital would still get along, but in looking for capital themselves they would have a slow and expensive time of it. The investment banker simply focuses this search for capital and facilitates the flow of funds from the lender to the borrower. It is a logical division of labor and each part does the work for which it is best fitted and in which it has specialized.

The tremendous importance of the work in modern days is quite apparent. Within 100 years the savings of individuals in the older European countries have opened up great new regions from which the world has drawn richly in foods and goods. New countries have not benefited alone. When, in old countries, great inventions have been conceived, it has been the savings of the people, collected by bankers, which have turned them from mere dreams into great aids to production. The railroad opened up new markets by its great transportation services and permitted a greater output through greater division of labor in manufacturing, and a use of new machinery, not only

supplied by capital, but made practical by other applications of capital.

Railroads in America made the great wheat fields of the Middle West available to Europe. The rubber of Brazil and of the plantations of the Far East would be out of reach were it not for the great and economical freighters.

Wherever capital has been directed by the bankers it has stirred and blown to life the spark of power. Botany Bay was once a waste and desolate spot. Capital turned it into a great center whence comes the food of millions. Napoleon said that it was "Pitt's gold," not the actual military strength against him, that kept him from the mastery of the world.

In recent years the investments of the English have been tremendous. They have been great not only in their own country, but also abroad, there being few nations in which Englishmen have not some interest. England has supplied the means for the development of almost all the new countries—that is, new within the past 150 years.

George Paish and Hartley Withers estimate¹ that the total amount of savings per year in the United Kingdom is £400,000,000, half of which is invested abroad and half at home. Not all of this sum is handled by the mechanism of the market, however. Paish says that the total foreign investments of the United Kingdom in 1907 amounted to almost £2,700,000,000, and Lavington believes that by 1920 this sum had

¹ Quoted in *English Capital Market*, Lavington, p. 87.

grown to £3,500,000,000. He adds that of this sum England's colonies and dependencies have shared about half and half with other nations. Paish also says that this foreign-investment total of England is about equal to that of France and Germany combined. We may realize, then, the great power that rests in the hands of the English dealers in capital.

Investment bankers often exercise other functions than the marriage of borrower and lender of permanent stock. They may do many services for their clients. They may accept deposits, handle bills of exchange, and perform other duties. But these are clearly subsidiary, and we may leave them aside, for our concern is to learn how the widely scattered capital of individuals is gathered together and dispersed into channels where it will construct and produce, and pay to its owner a rate of interest.

II

INVESTMENT IN ENGLAND PRIOR TO THE COMPANIES ACT

The development of the investment banker. Money lending—its early history. Early English banking. First brokers. Development of standardized investments. Foreign investments in the early eighteenth century. The Industrial Revolution. Rothschild, the “father of foreign investments.” Foreign investment and the Industrial Revolution. American railway financing.

SINCE the development of the investment banker is closely intertwined with that of investment banking, we shall have to discuss the two together.

Apparently, the first money lending was to governments or cities, principally in Italy, and centering in such places as Genoa and Venice. The advancement of funds by individuals who specialized in that business first appeared in medieval times. Before then, demands for very great sums of money were not numerous and were filled by merely seizing or taxing the wealth of the helpless merchants. There were few expenditures for internal improvements in those days, and when forts or walls had to be built the feudal lord would command the labor of his serfs. In war each man had his own equipment and no wholesale outfitting was necessary. The Crusades required funds, and much money was raised by the great lords by giving a city its freedom if it contributed hand-

somely to their chests. In Italy, especially among the Lombards of the north, sums were raised in mediæval times for the various cities by the money lenders. The chances were no more than even that these loans would be repaid. The business was a precarious one. In France we read that Philip the Second disapproved of loans¹ and “repudiated his debts to put an end to the villainous financiering”! Willis² mentions the merchants of Hansa as important lenders to the kings and emperors of Europe in early times. In 1487 the Fuggers, a banking family in what is now southern Germany, had attained much power as financial supporters of the royal governments, and enjoyed a wide reputation.

The lenders usually had certain taxes and incomes from the royal lands hypothecated to them, and the loan of money really amounted to the purchase of the privilege to secure what they could from this special assignment. The Jews are supposed to have gained a prominence in international finance in these days, because their religion did not forbid them to engage in usury and because the persecution by other races and religions compelled them to have their assets in extremely liquid form. However, these loans were in the hands of a few specialists in financing who used their own capital or that of their families, because the public did not save much and what they did accumulate they hid in their homes. The entrusting

¹ Lavington, *English Capital Market*.

² Willis, *Banking and Business*, p. 229.

of funds to others for profit making was not popular, and when loans to companies were made it was by relatives of those interested or by the great banking families. The bankers were really capitalists, not bankers at all, and they placed their own money where they thought it would bring the greatest profits. Thus they did not suit our definition of "investment bankers"; they were not intermediaries and made no effort to collect the funds of others.

EARLY ENGLISH BANKING

England was among the many borrowers from foreign money lenders, and the government relied heavily upon Amsterdam when that city became the financial capital of the world. We learn, however, that some English¹ capital was sent to Venice in the middle of the seventeenth century. When companies were organized in these times it was on a small scale and what little capital was necessary was supplied by members or friends. The first brokers appeared in the time of Edward III.² They were mercantile, not stock brokers. The old title for these people was "broggers" or "broceurs."

The goldsmiths grew numerous and powerful under Cromwell, and, while money entrusted to them was not exactly an investment, due to the great risks the depositor ran, yet the seed of the idea of placing money in the hands of others was planted in the minds

¹ *Historical MSS Commission, Appendix to Report VIII*, p. 134.

² *Duguid, Story of the Stock Exchange*, p. 4.

of the public. But there was no investing public as we understand it today, and the occasional opportunities offered to the people to subscribe money were in the form of single ventures or undertakings and amounted to the most hazardous speculations.

Between the Restoration and the Bloodless Revolution there was a great increase in English savings, probably due to the profitable trade of the early seventeenth century, but there were no safe investments and the money was hoarded.

Duguid says that the bonds of Charles II¹ "were hawked about the streets, especially at church doors, and were sold to the highest bidders." But in 1688² "the word 'stock jobber' was first heard in London." During the next five years many companies appeared, including the Lute String Company, Pearl Fishery Company, Glass Bottle Company, and a host of others. Companies³ to "import burros from Spain," to "supply education for youths," to "assure the making of fortunes," and, of course, the best of all, to "carry on a new and profitable undertaking, but no one to know what it is"—companies of this kind found no difficulty in securing money in 'Change Alley. While brokers dealt in these, they were chiefly brought out by promoters often calling themselves brokers, who sold the shares, pocketed the money, and left for parts unknown. Jonathan's Coffee House and Garraway's were the meeting places, and the writers of the times

¹ Duguid, *Story of the Stock Exchange*, p. 3.

² Aubrey, W. H. S., *Stock Exchange Investments*, p. 58.

³ Woolf, A. H., *Stock Exchange: Past and Present*.

termed the loans there floated "projects or bubbles." The reason for the popularity of these strange companies was that about 1690 or a little before, there seemed to be much surplus funds in the public's hands and, as always, there was a mad rush for something in which to place this money.

Charles I, Charles II, and James II all relied upon the funds of the London goldsmiths who kept their balances in the Royal Treasury, and it was all because those three "great and good" men had used the balances of the goldsmiths and had refused to pay them back that William III found it necessary in 1694, at the time when he was organizing the League of Augsburg and fighting Louis XIV, to establish the Bank of England,¹ which sold shares to the public amounting to £1,200,000 and then lent the whole sum to William.

DEVELOPMENT OF STANDARDIZED INVESTMENTS

The first public government loan was made on January 20, 1693, and subscriptions were taken by the brokers. In the same year the national debt was established, and so three comparatively stable investments for the public and business for the broker were supplied. This British debt was the first national funded debt. The famous "tontine" loans, originated in Italy, now appeared in England, engineered by brokers. In 1692 the first financial publication appeared. It was called the *Collection for Improvement*

¹ Andreades, A., *History of the Bank of England*.

of Husbandry and Trade and contained news of the various companies and loans.

Information of important events was highly valued by the brokers and many systems were organized by which news of battle and international intrigue could be relayed to London. Duguid¹ tells us that in the time of William III Sir Henry Furnese probably had a better information service than the government and was well posted on world events, and so was able to operate successfully in the market. He was the first to learn of the fall of Namur and profited well by it. He was presented a finger ring by William III in recognition of his services in raising funds for the government.

The culmination of the tremendous speculative fever in the reigns of William and Anne was reached in 1720 when the South Sea bubble collapsed. Fortunate individuals who still possessed their savings wisely stored away their gold coin until more dependable means of investing their money could be found. In 1720, the Bubble Act forbade all joint stock companies, and in 1720, Walpole passed an act² forbidding foreign loans without royal permission, in an effort to prevent foreign governments from making off with capital needed at home. This law was in force only two years, however. These stock companies were not a new idea, for they had existed since the Middle Ages. They had been originally organized by the

¹ Duguid, C., *Story of the Stock Exchange*, p. 28.

² Hobson, C. K., *Export of Capital*, p. 90.

trade guilds for the purchase of raw materials and by adventurers desiring to trade in foreign parts.

The British East India Company in 1600 was the first joint stock company to offer shares of an equal value and for set and convenient sums.¹ The joint stock companies were generally organized upon a charter granted by the crown, which conferred a special trading privilege or monopoly right. The growth in the number and popularity of the companies was steady and their history is linked closely with the development of investment banking, for they supplied standardized securities which could be traded in. Their rapid increase caused division of labor between investor and promoter, and the gap was bridged by the broker.

FOREIGN INVESTMENTS IN THE EARLY EIGHTEENTH CENTURY

The brokers opened their books in 1706 with a £500,000 loan at 8% to the Emperor of Germany. This loan was quickly subscribed by many investors who went to 'Change Alley for the purpose. This was the first public foreign-government loan and the brokers handled it well and profitably. They apparently advertised it through word of mouth only. In those times not all investors employed brokers; some took shares from the companies direct. The broker's function was chiefly to buy what he was told to and to sell his own issues if he could. Every broker had one

² Haney, L. H., *Business Organization and Combination*.

or more companies which he was anxious to promote. However, the brokers of the times were not always honest even when licensed, and in 1701 Defoe wrote his *Anatomy of the Stock Exchange or A System of Stock Jobbing*, in which he proved that the "scandalous trade as now carried on is knavish in its private practice and treasonable in its public!" This first book on stock jobbing advised the public to go to the Bank of England for advice,¹ so it seems that the brokers had not yet become sufficiently stable to serve as advisers. Robert Walpole, Prime Minister of England, said in 1716 that the brokers had combined and refused to support or advance money on a government loan which he was attempting to make at that time.² Perhaps this is the first complaint against a "money trust"! But it shows that the brokers of those days were sometimes more than the agents of their clients among the public and even had a part in the financing of issues. Loans to the government grew during the war of the Spanish Succession and throughout the eighteenth century. There were many needs at home for interior improvements. Hobson says that the national debt grew from £16,000,000 in 1702, to £128,000,000 in 1775, and £520,000,000 in 1802.³ As England's colonies grew, funds were invested there and the supply of surplus capital was sorely put to it to fill the hungry mouths of a growing industrial age. There was little money left for the

¹ Hirst, F. W., *The Stock Exchange*.

² Duguid, Charles, *Story of the Stock Exchange*, p. 37.

³ Hobson, C. K., *Export of Capital*, p. 86.

few foreign loans available when England's needs for development and wars were filled. Much British money was lent to Frederick the Great in his long wars on the Continent, and, in fact, when the English backed him against Austria they did so with gold rather than with troops. British capital was also used in other countries of the Continent, and London was gradually becoming a real competitor of Amsterdam.

When the American Revolution broke out, the brokers were called upon to provide funds. The total application for war bonds was £104,000,000. During the last part of the century, after demands upon England became heavier, loans became more profitable and even bank clerks traveled throughout the country and called themselves stock jobbers and brokers; by charging high rates for loans they caused the profession to fall into very great disrepute. However, foreign investments were growing and as Hobson says, "Stocks were bought and sold by the non-mercantile classes."¹

THE INDUSTRIAL REVOLUTION

During the last half of the eighteenth century there occurred in England the great transition from home to factory production known as the Industrial Revolution, and the great growth of factories and manufacturing towns called for British capital. The massing of many men and expensive machines under single

¹ Hobson, C. K., *Export of Capital*, p. 94.

roofs led to a very steady demand for capital, and bankers found themselves able to specialize in the collection and lending of funds. Also, the increasing number of capitalists supplied a steady clientele. The larger number of capitalists was due to the increased productivity of the new methods. The use of machinery, the division and specialization of labor, the broadening of the market on account of better means of communication¹—all enabled the operator of a plant to receive a little surplus for his income, a surplus due to the application of labor in new and more effective ways. This moderate-sized group of individuals who had extra money found that they could lay aside surplus funds from their budget devoted to living expenses. The possessors of these funds formed the germ of the English investing public. Their number increased with the development of the factory system, and gradually their total available resources became very great. As they looked about them for places in which to invest their money, they saw that certain undertakings offered greater profits than others. Ventures in foreign fields were very profitable to make but were accompanied with great danger, as the theory of limited liability was not recognized until the Companies Act of 1862.

After the defeat of Napoleon the demands of the English Government declined and at the same time war-ravaged Europe called for capital. The popular-

¹ Brindley constructed the first canal in 1758 to connect Manchester with coal mines seven miles away, and not long after John L. Macadam invented the macadamizing process for roads.

ity of foreign loans grew and special quarters were assigned foreign-loan bankers in the Royal Exchange. In 1819, Nathan Meyer Rothschild appeared as the father of foreign investment banking, and in that year contracted for a public loan of £12,000,000.¹ His loans were mostly to governments, and Reeves² gives the following list of his more important ones:

| | | | |
|------|------------|-------|------------|
| 1818 | Prussian | | £5,000,000 |
| 1822 | Prussian | | 3,500,000 |
| 1822 | Russian | | 3,500,000 |
| 1823 | Austrian | | 2,500,000 |
| 1824 | Neapolitan | | 2,500,000 |
| 1825 | Brazilian | | 2,000,000 |
| 1829 | Brazilian | | 800,000 |
| 1832 | Belgian | | 2,000,000 |

These loans were all issued at 5% and totaled £21,800,000. Rothschild did more than any other banker to make loans abroad popular. He facilitated interest payments for the Englishman when he arranged that interest on foreign loans should be paid in sterling, and it is said that he often advanced his own money to those to whom he had sold securities in the case of a default of a borrower. He came from a great banking family and his house is still one of the most important in London.

The growing interest in foreign loans is shown by the fact that in 1823 the foreign loan market moved from the Royal Exchange to larger quarters near the new stock exchange in Capel Court. It contained

¹ Duguid, Charles, *Story of the Stock Exchange*, p. 139.

² Reeves, John, *Rothschilds*, p. 176.

from time to time a varying number of members, between 400 and 1,000, and outside traders were admitted. Later it was combined with the regular stock exchange. The brokers used the rotunda of the Bank of England for dealing in Consols until 1834.

FOREIGN INVESTMENT AND THE INDUSTRIAL REVOLUTION

The extent of foreign investment was now great. New countries always lack capital and labor. While other countries had a share in supplying labor, it was for English capital almost exclusively to open up the means of transportation, to build the plants and machinery, dig the coal and raw materials, and set all in motion. But why could England do this? Why not France or Holland? These nations did share somewhat, but England was the great leader. England lent first because in that country there first appeared surplus funds to lend, and because the means by which she had accumulated these funds were a thing of the past to her and now she was able to supply money to other nations while they went through the same process. In other words, the Industrial Revolution occurred first in England and completed its work of reorganization and development there before it spread to other parts of the world. Other countries were just reaching the stage which England had so recently passed through. Furnaces and machines had to be built. Governments and enterprises in need of funds recognized that capital was compara-

tively plentiful in England and they hastened to London to get their share. The world was growing in its demand for productive instruments and the calls on London grew rapidly. England was the only nation that had a large surplus and "the earlier generations of Englishmen had saved their incomes and built and reasonably well supplied themselves with machinery of production,"¹ so she now was able to send capital abroad. Paish also explains that England needed food and raw materials for her large population and so was obliged to open up new producing areas.² That she did this consciously is doubtful. It is more likely that the higher interest rate for capital paid by the foreigners who dearly needed it furnished the real motive. It is almost axiomatic that unless risks are too great, capital will flow to that place where it is most needed and will, therefore, command higher pay. Paish is right in a sense, because capital invested abroad does constitute a claim on foreign products and there is no question that England's growth toward a non-sufficing manufacturing state required that she should have raw products from abroad. But it is improbable that investment abroad was done consciously for this purpose, and the real cause was the high rate of interest.

In America between 1825 and 1850 was an era of construction of canals, post roads, and some railways. These served to facilitate exchange and to make pos-

¹ Lavington, *English Capital Market*.

² Quoted in *English Capital Market*, Lavington.

sible large-scale production and consequently the construction of larger and larger plants. England shared in these developments more than any other nation. While there were, of course, tremendous developments to come in the next 50 years, yet her growth at the moment was far ahead of other nations. There were calls for capital at home continually, but not approaching in volume those from abroad. For the time her work at home was done. She turned to new fields. Much of the British capital exported was in the form of goods sorely needed by old countries exhausted by the wars, and by new countries which had no equipment to produce the goods themselves. Gilbart estimates that 626 companies were formed in the 10 years after the war for operations at home and abroad, and that the capital raised amounted to £372,173,000,¹ and the Statistical Society says that in the same period foreign government loans amounted to £93,000,000. Many, of course, were unsuccessful, but the tendency of the times is shown and the greater work for the investment bankers is important. Some companies for investment abroad were formed in 1825. They were not successful, due to lack of provisions for limited liability.

England's merchant marine was strengthened by the participation of the British in foreign development because, since they had, in the first place, most of the freighters, it was natural that the new transportation business should go to them. The cargoes

¹ Quoted in *English Capital Market*, Lavington.

on both the outward and homeward voyages increased as the population increased in the new countries and as they produced more goods which were desired by the peoples of Europe. The use of the pound in international finance also owes its preeminence to the great quantities in which it was distributed about the world at this time. Another increase in the foreign security holdings of the English is due to the fact that they had to accept securities of railroads and other companies as payment for the tremendous amounts of manufactured goods which they exported.

AMERICAN RAILWAY FINANCING

In 1838 the Rothschilds sent August Belmont to the United States to handle investment interests there, particularly investments in railroads, whose popularity was just dawning. Other foreign investment houses sprang up, such as Speyer, who dealt chiefly in railroads, and the Barings grew in importance. Other types of American securities, such as those for canals, were well known in England by this time and were dealt in by investment houses. Bell and Son, outside brokers, issued many American securities and kept brokers distributing them. The panic of 1837 wiped out many of these financial houses, but others appeared to take their places before many years.

In the 40's, railroads offered many new opportunities for investment. While England was building her own there was little surplus of capital for foreign

roads which therefore had to be opened up afterwards. The interest in the new transportation companies was so keen that a boom in their shares occurred, known as the "railroad mania." Twelve hundred sixty-three companies were formed, prospectuses were flung about broadcast, and the excitement was equaled only by that of the South Sea bubble. A short time later the railroads of other nations had to be built and the network of lines in both North and South America is due largely to the wandering and adventuring spare capital of the English, hindered for a moment by the panic of 1847.

Between 1840 and 1850 we find Baron Lionel Rothschild leading the British public in foreign investing. In this period American railroads drew much capital, and there were many buyers and sellers of shares traveling about the country calling themselves investment bankers. But before this wide publicity was given to railroad shares, the public could secure them from only four or five brokers, and only a few jobbers existed. Gradually the market for railroads widened out and the number of brokers and jobbers increased as stated above. By 1850 the savings of the country had greatly increased and the political stability of the period swelled the flow to investment bankers, whose members increased as the demands from new countries matched the idle British capital. Many home demands for funds were met by acquaintances of the owners of the industries in question. This fact accounts for its appearing that most

investing was done abroad, while in reality a tremendous amount of expansion was financed by persons in the locality of growing plants. Lavington believes that the simple structure of English investment-banking houses is due to this method of local financing.

III

THE COMPANIES ACT OF 1862 AND THE SUBSEQUENT POPULARIZATION OF INVESTMENT IN SECURITIES

The Companies Act and limited liability. Joint stock companies registered in the United Kingdom under the Companies Act since 1862. Increase in number of small investors. The London stock market. Jobber and broker. Selection of securities admitted.

BETWEEN 1850 and 1875 the English capital market was supreme. London bankers supplied funds to all countries, while people with surplus funds placed them in London. No other nation equaled it in number of investment bankers or challenged it in the amount of its issues. Foreign governments jostled each other in their desire to be served by Rothschild, Baring, and similar houses.

But the most important stimulant to investing was the Companies Act of 1862. This Act, together with the fact that the Industrial Revolution occurred earlier in England than in other countries, apparently accounts for the leading role which Great Britain has taken as world financier. The Industrial Revolution supplied the means and the Companies Act of 1862 supplied the method. By this Act the theory of limited liability was established, and an investor placing his savings in an enterprise knew from the start

just how great his responsibility was to be. This was a great boon to the investment bankers, for immediately shares became within the reach of the small saver, and new sources of capital were open to the banker. The investment of funds was to be democratized, and small brokers sprang up throughout the country in every town to collect the surplus capital and to relay it to London. The importance of reaching the small investor was presented to the investment banker, who had heretofore dealt only with comparatively large capitalists. The use of the local broker as a share distributor is one of our chief concerns and we shall consider it in a later chapter.

THE COMPANIES ACT AND LIMITED LIABILITY

When limited liability for security-holders was established there was a great rush to get into the foreign fields. A large part of the risk was eliminated and everyone who possessed surplus funds went after the higher interest rates prevailing abroad. Viscount Goschen tells how the home rate rose to 7% in an attempt to secure funds needed in home undertakings and to stem the flow from England,¹ but the capital continued to be exported with great rapidity and in large amounts, with occasional periods of hesitation when military or industrial crises upset the stability of foreign borrowers. The only definite stop that could be put to the outflow was either by the raising of the home interest rate to equal the foreign one, or

¹ Viscount Goschen, *Seven Per Cent.*

else the surfeiting of the foreign demand for capital by its own increases in growth of saving. The importance of the Act is shown by the fact that in the year 1862, 165 companies were formed with capital of £57,000,000. With previous unlimited liability only a few firms with large capital entered foreign trade. The amount of capital to be invested was limited to the amount of their own resources augmented by whatever credit they could demand. "Each bore the whole risk and so was unwilling to go beyond a certain length in dealing with countries where financial operations were risky."¹ The accompanying table² shows the number of companies formed under this Act at intervals since 1862, and their total capitalization.

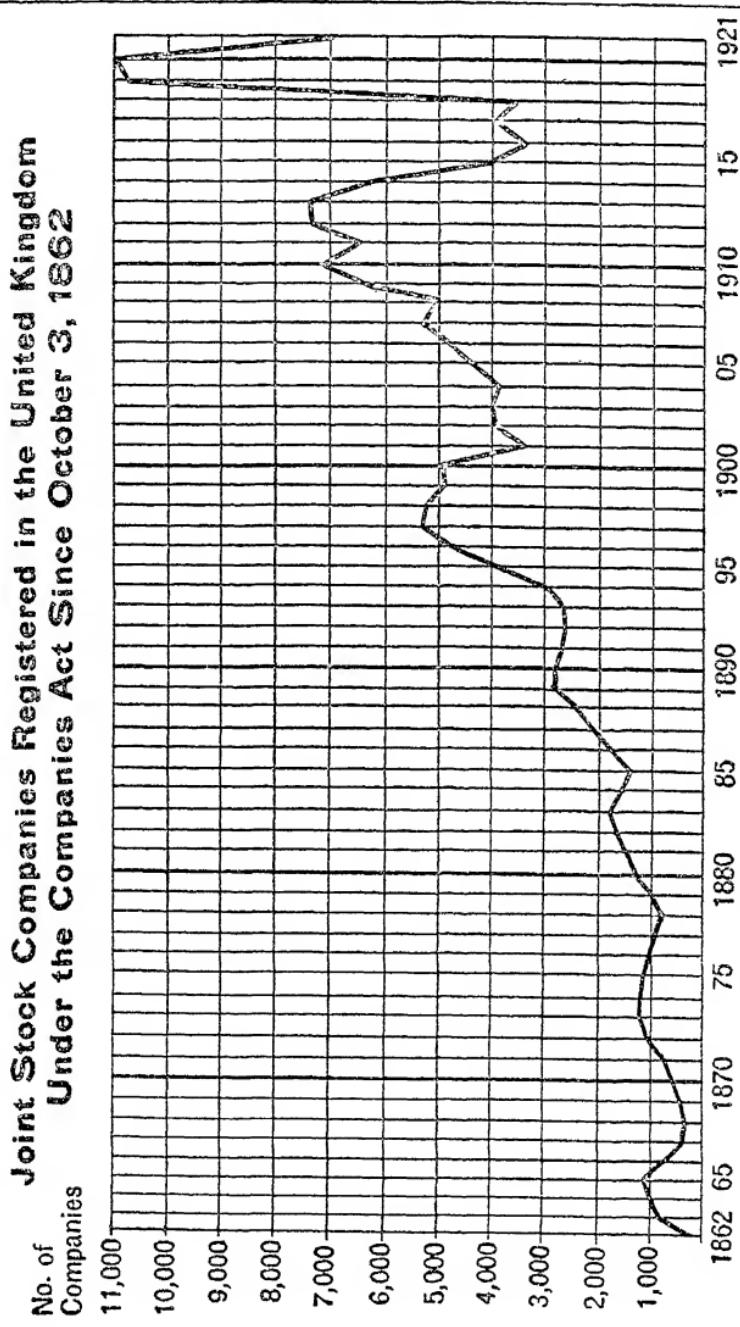
| Year | Number of Companies Organized | Capitalization (millions) |
|------|-------------------------------|---------------------------|
| 1862 | 165 | 57 |
| 1872 | 1,116 | 133 |
| 1882 | 1,632 | 254 |
| 1892 | 2,607 | 103 |
| 1902 | 3,909 | 157 |
| 1912 | 7,367 | 174 |
| 1914 | 6,214 | 113 |
| 1916 | 3,993 | 50 |
| 1920 | 11,011 | 593 |
| 1921 | 6,956 | 109 |

The chart on page 28 shows the number of joint stock companies registered under the Act since 1862.³

¹ Viscount Goschen, *Seven Per Cent*, p. 25.

² *Stock Exchange Official Intelligence*, Vol. XL, p. 1790, 1922.

³ The data for this chart were taken from the *Stock Exchange Official Intelligence*, 1922, Vol. XL.



It is interesting to note the fluctuations in the numbers during periods of depression and wars. The stimulus to the forming of companies was great and the trend has been steadily upward.

The Act also gave a great impetus to foreign financing by investment trusts, about which more will be written later. These trusts chose foreign investments and purchased them with money realized from the sale of their own securities. They enabled the small investor to put his money abroad under good guidance and take advantage of the high interest rates. Viscount Goschen wrote in 1865 in connection with these trusts that the "limited liability of each shareholder became one of the chief elements in an unparalleled suction, a minute and complicated drainage brought to bear upon the scattered capital of the country."¹ He added that the drainage would last until the financial organization failed. This organization is very similar to the one now existing, so in the early 60's the foundation for greater participation in foreign fields was made by the bankers.

INCREASE IN NUMBER OF SMALL INVESTORS

There were other encouragements to the great democratization of finance, and the possessors of the smallest bit of capital could now find a market for it. It became the regular thing for persons in every walk of life to hold securities of some amount. Cheap newspapers and reading matter educated the public

¹ Viscount Goschen, *Seven Per Cent*, p. 23.

to investment opportunities and the benefits of frugality, and a higher standard of living gave them a desire for security and comfort found in a steady income. The theory of geographical distribution of risks also found credence, and although now somewhat discredited it did much to spread into many lands the savings of the public. This theory advocated that the investor "carry his eggs in more than one basket"; that is, that he should place his investments in several widely separated countries in order that panics or crises in one direction would interfere with only a part of his income at any one time. Rapid means of communication and closely interwoven and world-wide methods of production now render it much less likely that disturbances will not be felt throughout the world at the same time. Of course, proper diversification is wise, but protection is best found by sound investments in diversified industries and companies—not in different lands only.

In 1868 the Corporation of Foreign Bond Holders was formed. Its object is the protection of interests of holders of foreign securities. It uses all means in its power to prevent defaulting by foreign states or companies and has made settlements for its members amounting to a billion pounds since its formation. The membership fee is not large and is used to defray expenses of legal advice and investigation of the foreign bond issuers, chiefly governments. In the published reports of the results of its analyses the public possesses another guide. In 1875, the Foreign Loans

Committee was organized to look into the condition of foreign applicants for loans in order that there might be less defaulting among borrowers, but this did not turn out successfully and was abandoned.

In the 70's there was some falling off in British investments, due to the strains on business arising from the American Civil War and the Franco-Prussian War, but recovery came before long. Our next estimates for the investments of England, supplied by R. L. Nash and quoted by Hobson,¹ assert that the total for home and abroad amounted to approximately £3,500,000,000 in these years. In the last quarter of the nineteenth century we find a great development of commerce attended by improved transportation and communication. Germany consolidated her industries and banking methods after payment of the indemnity by France.

Investments increased steadily. There were occasional hitches due to the silver controversies in the early 90's and the wars against the Boers and between Spain and the United States. Gradually a greater confidence was felt in home and foreign industrial securities. The wealth of the world was rapidly multiplying and investors used their new wealth to stimulate the great national industries. This great increase in capital in other nations beside England freed the world from its almost complete dependence upon British bankers. Yet England still brought out the lion's share of the foreign government loans and still

¹ Hobson, C. K., *Export of Capital*, p. 145.

distributed the nation's money throughout the world, because just as had been the case since the days of the Industrial Revolution, the opportunities for investment in England were quickly filled up and investors had to turn to comparatively new countries. Investment expansion was tremendous, and the ease of placing funds was greatly facilitated by knowledge of foreign countries and by rapid means of communication.

Investment banks have advanced with the growth and integration of industrial enterprises, which they helped to expand and to combine, for the days are gone when the great companies can collect sufficient capital for their needs from a circle of friends or relatives.

THE LONDON STOCK MARKET

The London stock market forms a great market in which securities of governments and companies may be bought and sold. It is purely a market. It deals with investment only in so far as it consists of a reservoir from which old securities may be drawn when needed. Securities on the Exchange are all "second-hand." They have been held by an original purchaser from the company issuing them in the first place. It adds to the attractiveness of a security in the view of the first purchaser that it may be readily disposed of at a fair price in the market. Consequently, the presence of a great open place where many securities are bought and sold is very important. Se-

curities dealt with in the market are generally seasoned and have established various reputations. In short, the market is not the means by which new capital is secured for new enterprises.

In 1922 the *London Stock Exchange Year Book* listed and described 11,500 companies. These all constituted potential investments. In the entire United Kingdom in 1920 there were on the register 79,541 registered companies having a share capital, and, in addition, there were 66,543 private companies.

By far the most important exchange, not only for Great Britain but for the world, is in London. Here are dealt in the issues of nearly every government under the sun. No other nation has so many calls upon it for funds from different quarters of the globe and in such great quantities. Railroads, construction and shipping companies, companies to perform manufacturing, distributing, or investing functions, all come to London. The Official List of the Stock Exchange carries several thousand securities, and the number increases yearly. There is no better way to appreciate the size of the market than to examine this list, which contains each day the names and prices bid and asked of all securities dealt in that day. It consists of about 15 closely printed pages and is published by the Stock Exchange Committee.

JOBBER AND BROKER

Let us see how the market operates; we have indicated its extent. On account of the great number of

people who desire to deal in securities, it became impossible long ago for the public to go to the market and to buy and sell for itself. Gradually agents appeared who would deal for the public in return for a small commission. When this happened the real Exchange was born. The distinguishing feature of the English Stock Exchange is that there are two distinct types of operators in the body. One of the groups is called the jobbers and the other the brokers. It is the function of the jobbers to remain upon the floor of the Stock Exchange Building and to deal with the brokers, who come to them from their offices supplied with orders from the public to buy or sell certain securities. When the broker receives a wire from a client in the country requesting him to buy 500 of the Aerated Bread Companies 6½% Preference shares, he will enter the order in his notebook and hasten to the Exchange. There he will proceed to the section of the floor where congregate the jobbers dealing in home industrials and will ask for a price on Aerated Bread *without stating whether he intends to buy or sell*. In order to establish a reputation as a clever dealer, the broker wants to get the shares as cheaply as possible for his client. The jobber will immediately quote two prices, one at which he is willing to buy and one at which he is willing to sell a reasonable amount of the stock. The difference between the two prices constitutes the jobber's "turn," or profit. This "turn" will be greater with less active securities in order to compensate the jobber

for the risk that he might not locate the securities at the price he quotes.

While the jobber may be said to make the market because it is he who quotes the prices, he must have business from the broker. There are several hundred jobbers on the London Exchange of varying degrees of ability and each of whom has a special field of securities in which he deals. There are special sections of the Exchange where "Yankee" rails are dealt in, another for "Kaffirs" or South African mining stock, and so on. In each general section will be found the eager jobbers prepared to deal in their specialty. The jobber deals with the broker only.

The existence of broker and jobber tends to give a broad and active market in which many securities are dealt in with the greatest freedom. Prices are thus made close and it is not difficult to find the securities sought. There are, of course, a great many securities not entered on the Stock Exchange. The more active ones not so entered are dealt in between brokers.

SELECTION OF SECURITIES ADMITTED

The Stock Exchange Committee, or governing body, deals chiefly with points of order and procedure. It regulates methods of dealing and sees that debts are promptly paid. It makes practically no attempt to assure itself of the soundness of the companies whose securities it admits. There has been some agitation to have it act in a supervisory capacity and

to choose carefully the securities admitted. However, it has on the whole been its policy not to do this. It is felt that, if the general public should get the impression that the Stock Exchange Committee effectively culls out all worthless securities and that therefore all those entered are sound and guaranteed, the result would be the placing of funds thoughtlessly into all entered securities without examination or inspection as to the real merit of the borrowing companies. In short, the Committee feels that the public should think for itself within reasonable bounds.

Settlements between buyers and sellers are made fortnightly except in the case of government securities, when the period is longer. Settlement upon the determined days may be avoided by paying a postponement fee, known as the "contango." The contango rate varies with the market rate for money. The buyer of securities may also secure the privilege of not taking the shares he has bought. This is accomplished by the payment of a "backwardation" fee, a sum paid by the purchaser of a security to the seller for the privilege of not taking that security upon the day when its delivery is due.

One of the phenomena of the London market is the "closing up" of the market. At certain periods the public will refuse to deal in securities and the market will "close up" as tight as a drum. While this occurs in other stock markets of the world, it does not approach in intensity the closing up of the London market. There will be no business to transact and the

jobbers will mope about in the most dejected manner. Contrasted to such periods are the times when the public is "on the feed" and the market will burst into feverish activity. The people will turn their attention generally to a particular class of securities. Recently rubber has been the object of this attention. Over a half-century ago it was railroads, marked by the so-called Railroad Mania. At such periods, money will pour into the market, new companies will be formed and old companies will expand to get their share in the flow, and the foundations for a crisis will be laid.

While the range of dealings in London is tremendous and greater than that of any other nation, yet the intensity of speculation and action that sometimes develops in New York may exceed that in London. Much of this is probably due to the greater facilities for rapid communication in America, where every broker possesses a "ticker" in his office and very often a board on which the latest quotations are quickly chalked up. However, this rapidity of action is not at all essential and London leads because of the great breadth and volume of its business, not on account of the speed of its turnovers.

Thus we see that there exist all the facilities for the disposal of stock once it is in the hands of the public. The securities are in the public's hands and the Stock Exchange exists as a clearing-house where the wants of the people may be set against each other.

IV

CHARACTERISTICS OF ENGLISH INVESTMENT BANKING

Functions of American, versus those of English, investment houses. The London investment market. The German system of investment banking. Failure of English investment houses to interest themselves to a large extent in home industries. The British Trade Corporation. Plans for local credit associations.

THE investment machinery must draw forth the savings of people throughout England and turn them into the channels where the interest is profitable and the risk not too great. When an industry needs equipment with which to start, or an addition to its already existing plant, its directors will come to the City (or London's financial center) for their money. The City has three functions to perform, each one of which will be discussed in its turn. First, the government or company applying for advances must be investigated and its accounts analyzed. Then, if found satisfactory, its securities may be underwritten or their sale insured, so that even in case the public does not fancy the issue, the company or government will have its money. Finally, the securities must be marketed. This is the most important step of all, for it is the investor who supplies the money and his interest is essential to the success of an issue. There are different ways of accomplishing the distribution.

In America all of these functions are generally taken care of by one type of bank—the investment house. While the houses vary greatly in size and, therefore, are more or less limited in the business they may handle, they all utilize the same methods. When an issue is too large for a house to handle by itself, it will invite other houses to join in the work. The original houses will take over the securities from the issuing company at a fixed price and will resell the securities in blocks of various sizes to smaller investment houses at a slightly higher price. These latter houses may subdivide their allotment from the original or wholesale house by distributing amounts of the securities to other houses. And so the distribution continues through a long line of houses very similar except as to size. And in this way practically every issue of securities is floated.

But in England the situation is entirely different. We find the different work in the complete flotation of an issue of securities participated in by a large and heterogeneous group, each member of which has its own work to do. Yet the work is done more simply and more directly, for there is a greater centralization. This will become clearer when we examine each of the three main steps in turn.

THE LONDON INVESTMENT MARKET

The London investment market comprises a mass of issue houses, promoters, issuing brokers, investment trusts, ordinary brokers, banks, and underwriters.

There is no firm line dividing the work of all these types of houses, but there are two main divisions. One division issues, or brings out; the other distributes. While it is true that each type of house has a slightly different character, yet in practice each will operate in about the same manner, except that the two acts of issue and distribution are almost always separated. It is necessary to include the "almost always," for there are occasional exceptions. Underwriting, in the sense of insuring the sale of an issue, while a special function, is not undertaken by special agents but is handled by any of the operators named above or by private individuals with large capital or credit. The investment trust is an unusual kind of organization of a rather hybrid nature. It occasionally issues, it usually distributes the shares of many lands and industries in an indirect way, and it frequently underwrites. Therefore, the machinery with which we are dealing is somewhat unorganized. Companies or governments needing money are accommodated in a number of different ways. The methods of issue are more complicated than those for marketing. When an issue is to be made there is a choice of various organizations which may be used; however, since the means of reaching the investing public are few, distribution must always be made in about the same way.

The value of the work of issue and distribution lies in its cheapening the cost to the borrower of funds and its finding a place for the lender to invest his money. In addition, an important selective act is

exercised in the process. The company in need of capital and the individual with idle funds need not search for their requirements unaided, because the machinery of the London capital market brings them together in a single place where they may bargain on an even basis. Without this mechanism much time and capital would be wasted in the attempt of borrower and lender to get together. Less capital is likely to lie fallow when an efficient means of utilizing it is at hand. The possibility of its going into unproductive uses is minimized when the lenders in a market scrutinize the borrowers who approach them. The importance of this selective function of the issue houses, brokers, and other representatives of lenders is very great. They must appreciate that the future economic development of an industry or a locality, and sometimes even of a nation, rests in their hands to an extent little realized by the general public. Controlling vast sums of capital, the very life-blood of a new enterprise, they are able to direct the course of progress to a surprising degree. Suppose that the bankers of the early nineteenth century had not supported the efforts of the young railroads—what a difference in industrial growth would have resulted. Large-scale production is limited by the size of the market and the size of the market is limited by the means of transportation available to widen that market. For such an important adjunct to civilization as is the railroad, capital would have eventually been scraped up but only after much more time and effort

had been expended. This evidences, however, the importance of the selective function of these members of the market. That this power will be handled wisely is probable because, fortunately, the most economically sound project is generally, in the long run, also the most profitable. Consequently, the interests of issue house and public run in parallel lines.

The first, or issue group, receives the request for capital from the borrower. The request is considered and, if found satisfactory, securities are prepared and then are referred to the second, or distributing group, whose business it is to see that they are placed in the hands of the public. Warburg recognizes the divisions of issue and distribution and states that the investment of funds rests chiefly in the hands of the broker, "while the contracting of large loans and formation of syndicates is left to private firms, or if foreign loans, to banks specializing therein."¹ British investment banking not only divides up its work in this way, but it also possesses other distinctive features.

SPECIALIZATION IN LONDON INVESTMENT MARKET

British banking consists in banking alone. It considers its duty to be finance only and does not care to enter into industry itself. An English banker would consider it absolutely unsound for him to take part in the development of a country or business, except

¹ Warburg, Paul M., *American and European Banking Methods and Legislation Compared*.

as the financier. He believes that a banker should never be a partner and that when once the money has been supplied to a borrower, it is up to him to make his own use of it. A British investment firm would not think of building a foreign railroad and then holding its securities in order to participate in the rise of land values likely to occur. It will simply advance the funds and then get out. The changes in value of the securities will be obtained by the public, to whom the securities have been sold, and the investment house will have made its pure banking profit by receiving the difference between what it has contracted to pay the borrower and the price charged by it to the public. It is considered essential to sound banking that the "banker shall never be a partner." In other words, as soon as the banker starts to rely for his profit upon fluctuations in the value of the securities that he has taken over, a new element of risk has entered and the banker has stepped from his proper role and has become a sharer in the business risks just like the owners of the business to whom he has loaned money. W. R. Lawson quotes¹ the old Lancashire proverb to describe the investment banker's devotion to duty: "Every man to his own job," and compares the English with the German system, commanding the latter for the participation which the banker takes in industry and citing the rapid development which both banking and industry have had in the latter country. He is

¹ Foxwell, H. S., *Financing of Industry and Trade*.

probably right in thinking that the relations between British investment houses and home industries should be developed and that responsibility for the success of the latter should be felt by the bankers, but at the same time many have come to feel that the German method is not sound and that bankers have become to a too great extent the managers of industry instead of being the suppliers of funds. The German scheme operates satisfactorily in periods of expansion when new sources of production and new markets are being rapidly developed, because profits and wages are all swept along in the swift, upward flight. But when the inevitable depression occurs, when production increases too rapidly and gets out of control, the system collapses. The banks which have participated to excess in the businesses which they are financing will be unable to extricate themselves in such periods and their capital will be "frozen up" with their favorite industries. This situation existed in the "rich man's" panic of 1904 in the United States, when the undigested securities of such huge combinations as the United States Steel Corporation clogged the banks of Wall Street. The German system was successful in the years of expansion from 1875 up to the time of the war, and, in fact, the tremendous growth of Germany as an industrial state is a result of this banking assistance, but the extent to which future action along similar lines is practical cannot be considered great—it appears that the usefulness of such a forcing process is past. The English investment houses stand

aloof from industry and commerce and maintain the attitude that every unit in the business world has its function and that their part in the work is to supply long-time loans and to do no more. Their risk lies in the disposal of the securities they have taken from a company; it does not lie in the failure or success of the firm after they have given it its funds.

The degrees of responsibility that the various issue houses feel for their securities are many, but it appears that their interest in them has developed within the past few years. Some of the houses still feel that their function is financing alone and that, when they have once floated an issue, their relation to the borrower is severed. The German banking system has been held up as an example of what complete cooperation between investment houses and industry will accomplish, but British banks have not followed suit.¹ They are more conservative and prefer to exercise their banking functions in as narrow a field as possible, although perhaps scrutinizing with greater care the condition and prospects of the borrowers who come to them. Their interests are financial and will probably always remain so. If they decided to tie up their capital for a longer time than they do, and to hold the securities for a rise and perhaps operate in the market so as to create an unusual demand, they might do so. But they prefer to employ their capital in rapid

¹ "In 1907, Dr. Jaffee, speaking at the Third German Bankers Convention at Hamburg, said that 'English banks furnish money for flotation and stock exchange business without thereby securing the slightest control for themselves over the speculation.' "—H. S. Foxwell, *Financing of Industry and Trade*.

turnover and to collect a purely banking profit. In this way they avoid industrial risks and perform the functions for which they say they were created—to supply funds, not to manage industry. They only establish a market by having a jobber or two work up the price of their issue while it is being marketed, and so stimulate interest and curiosity; they do not expect to unload in the market at a higher price after holding the securities during the agitation.

Foxwell feels that the specialization has been carried to an extreme and that the system has suffered from this and from a lack of organization. The investment houses could serve as supports and guides to business by assuming a little greater responsibility and by not losing interest in the companies as soon as their financing had been accomplished. A company can find no ready substitute for the information and advice that issue houses or large brokers might give it. The latter have a deep knowledge of proper methods of financing, not only concerning the best times to borrow funds, but also concerning the best types of securities to interest the public and to place the least burden upon the borrowing company. Again, a financial agent of a large city banking house can submit budgeting plans and prepare for future refunding more ably than can the heads of industrial concerns, whose interests and abilities lie chiefly in methods of production. Also a banker is more likely to have a broad and far-sighted view-point because of his familiarity with conditions and prospects in a wide field

of industry, which are often foreign to the industrial head. The banker is the recipient of news of every sort from all parts of the world; he is familiar with the general trend of prices and the present and probable future supply of credit, all of which helps him to determine the future course of business. This knowledge enables him to anticipate, to some degree at least, slack times and crises. If such opinion and judgment were more directly available to the heads of companies, much good should result. Foxwell also supports the German system in these words: "British industry has lost valuable advice that a German bank or issue house could offer, advice that is often more valuable than the mere capital loan; while banks, in turn, lose a certain insight into the industrial and trading system which might go far to compensate them for any risks inherent in the more difficult type of finance."¹ It is important in discussing the English banking system to realize that in England the term "banking" is used in a particularly narrow sense and refers to the activities of commercial banks, or banks that specialize in short-time loans to finance the day-to-day processes of business turnover. They have no concern, of course, in supplying the original or additional equipment of governments or companies. As used throughout this book, however, there has been no attempt to preserve this exactness of English terminology. Commercial banking is not dealt with here; we have to do only with investing banking.

¹ Foxwell, H. S., *Financing of Industry and Trade*, p. 127.

The failure of the English investment houses to interest themselves to a large extent in home industries is considerably due to their preference for the more substantial securities of governments or municipalities, or additions to the already existing plants of well-established businesses. The machinery is excellently fitted to handle this large foreign business. However, the discrimination by the British issue houses of what they shall take under their wing is the distinguishing mark. It is an unfortunate thing, too, because if they would secure stability for their issues by keeping their eye on them after flotation rather than by limiting what they issue to the most sound and conservative governments and companies, they would be of great assistance to home industries. At present there is no real intermediary by which new ventures may be floated.

THE TENDENCY TO NEGLECT FINANCING OF LOCAL INDUSTRIES

Before the war, the situation was considered very serious and it was pointed out that all England's capital was being exported to help foreign nations develop, while industries at home had not the means to take advantage of advances in methods of manufacture or to purchase new and up-to-date plant and machinery because they could not even get a hearing at the issue houses. In a way, however, the veto power of the investment banker is not so great as in America, because in the latter country, if a banker

refuses to handle a company's issue, it is virtually impossible for the company to get capital elsewhere. In England it is only the weak companies that may be shut out. The strong industrials may go to the public themselves, and, in fact, it is estimated that approximately 60% of the industrial issues made each year are handled by the companies themselves. The contact between the greatest financial market in the world and the industries of the same country is thus very imperfect, and it is unfortunate that the splendid organization existing for the handling of government and large railroad and similar loans cannot be applied to home needs. As a matter of fact, in recent years and especially during the years since the war, the attention of investment bankers and the public has been directed to home industry and the banks have entered more and more into the financing of these concerns. A closer union between the heads of industry and financial leaders has resulted and the latter feel a greater responsibility for the companies whose securities they have brought out. But this is not true throughout the investment banking field, and the participation of the banker in business is a matter of degree, varying with every house.

In 1917, the British Trade Corporation was formed for the purpose of directing surplus funds into investments in industries. The need for capital was felt and the intention was to supply a means through which capital for national use alone might be placed. Development of a means for supplying capital is nec-

essary, but it is doubtful whether higher interest returns to be obtained in the securities of more distant concerns may not form a too strong attraction, so that capital will flow abroad again as merrily as ever.

Intermediary organizations to serve home industries have not developed, because the private wealth of individuals has supplied capital to industry through the medium of friends or business acquaintances and recourse to the market has not been necessary until comparatively recent years. Industries have not dared to go to investment houses for funds, feeling that to be a sign of weakness. Businesses were expected to finance themselves from their own funds or from the surplus sums of local people or members of the proprietor's family. There was no attempt in the past to market shares far and wide throughout the country and financing was thought to be a very private and local thing, except for the great loans which had to be made to governments, cities, or railroads.

Furthermore, one of the principal reasons why the investment houses have not handled more English industrial companies is that these companies have been slow to increase in size and to form the large combinations so familiar in America. While England was the first country to adopt the factory system of production, progress beyond that stage has been slow and benefits of very large-scale production in that country have not been fully utilized. There are large companies—as Vicker's, for instance—but that is the exception and not the rule. The result has been that

most companies have not required huge issues of securities to facilitate combination and growth. Even in America, where the pace in this direction has been rapid, it is a comparatively few years since the textile industry organized upon a large scale—the American Woolen Company was the first to appeal to the public for funds in this field. Then, too, the old families that founded the fundamental British industries have been very unwilling to let them slip from their grasp. Control, or even participation in the earnings by outsiders, did not appeal to them and this feeling has been a strong hindrance to their borrowing from the public. It has been only the competition from other large-scale producers that has driven the older companies to expand. The process has been slow. It is not entirely the fault of the investment houses that there is not a better liaison between them and the industrial companies of their own country.

There have recently been several plans for local credit associations to supply the needed capital to industries whose needs were so small that a large appeal to the public would be unnecessary and probably unsuccessful on account of its insignificance. The cotton spinning companies raise additional capital by opening deposit accounts for local people, who are familiar with the industry and have faith in those who are undertaking it. This has been particularly successful in Oldham.

In a few words, the chief difficulty with the investment banking organization is that it has not been

tuned to handle the financing of local industry, but depends for its business upon great foreign-government issues or on such large-scale undertakings as railroad construction, or production of a few basic materials such as steel or copper, by a few very large companies. The system neglects the medium-size industry, and the result is that the machinery is not fully available to all and many must forego the capital market for the more expensive and risky direct appeal to the public. The investor would be a great gainer by the association of the City mechanism and industry, for some guarantee, or support at least, would arise between the two.

At present only about one-quarter of the capital passing through the market is destined for home use. Of 6,542 companies formed in England in 1912, only 378 were public companies with prospectuses, and of the latter only one-half were floated in London.¹ Most of the capital for the smaller companies, therefore, is secured by private negotiation and no attempt is made to utilize the London market.

Before we examine the work of issuing, we must understand that by far the greater part of capital supplied to business in England is derived from private means and not from the public. It is with the public machinery that we are concerned. Consequently, it is clear that we shall deal with machinery employed to furnish funds of large amounts to a comparatively few companies, and, of course, governments and

¹ Lavington, *English Capital Market*.

states. The fact that in 1904, 3,477 new companies were registered and of this number 3,068 made no public appeal to the private investor gives further support to this assertion.¹ Nevertheless, while the number of companies served is small, the capital supplied is very great. The groups which look to the London market for capital are reduced, therefore, to a small number of governments, municipalities, and a few large foreign and domestic industries whose names and reputations are known throughout the country.

¹ Lavington, *English Capital Market*.

V

THE ISSUE HOUSE AND THE PROMOTER

Differences between the issue house and the promoter. Borrowing without the aid of an issue house. Competition among issue houses. The work of issue. Reason why English houses do not divide up the participation in an issue among several houses. Underwriting issues. The prospectus. The British Stock-Brokers' Trust.

ISSUING consists of preparing securities and starting them towards the hands of private investors. The completion of the act of issuing is accomplished when all the securities have been distributed. But, as stated above, the work is in two parts—issuing and distributing. The completion is managed by a second group. In England there are three methods of starting the issue of shares. The government or company in search of funds may employ an issue house, a promoter, or may make the issue itself. If either of the first two methods is adopted, there is at once a division of functions in the complete distribution of stock. The promoter or the issue house will put the issue into shape and then call upon the brokers, who are scattered in great numbers throughout England, to help them dispose of the securities. If the borrower prefers not to use a promoter or issue house, he will deal directly with the brokers himself.

The issue house is really a glorified and permanent promoter. Both have the same functions and

operate in the same way. There are only two differences between them. In the first place the issue house has a continued life and may, therefore, feel some responsibility for the issue it makes, because it realizes that if it brings out many unsuccessful securities it will lose whatever reputation it may have enjoyed. The second difference is that the issue house, having a permanent office and a well-established reputation, may engage in other lines of business in addition to its chief specialty—that of issuing. It may receive deposits, open letters of credits, or transact other similar banking operations.

THE PROMOTER

The promoter is quite different. Usually an individual, he steps from one venture to another without a thought as to the success of the last. His object is to sell as quickly as possible the securities of the project in which he is interested and then to be off, with an eye for another opportunity to repeat the operation. Undoubtedly the promoter came first, historically. He was the keen and intelligent person who eternally searched for an opportunity that was not being utilized. He was not unlike the entrepreneur; in fact, he worked hand in glove with him. The entrepreneur would see that a demand for some kind of goods existed, would secure a place and managers to manufacture it, and then would send for the promoter to sell the stock to get the money to pay

for it all. The promoter would look the situation over, investigate the strength of the demand for the manufactures, and, if satisfied, would undertake the issuing of the securities.

The promoter's methods are not the best by any means, and it is very much to be hoped that he will be replaced entirely by the issue house. The promoter feels no responsibility for an issue and the tendency is for him to "water the stock" and so secure a handsome slice for himself. For a great market where large amounts of capital are accumulated, it is surely not the best arrangement that can be made when an individual or a small group can get together, decide that a project has an appeal to the public, have securities printed, distribute them, and then disband with their profits and their future careers in no way affected by the outcome of their promotion. To the promoter a successful flotation is most important of all, the success of the venture being less important. His interests, therefore, are distinct from those of the purchasers of the securities, and if he can sell worthless stock he is very often willing to do so. The promoter is always on the lookout for the direction public choice will turn and he is prepared then to bring out rubber, oil, or mining shares, just as the public wishes, considering only what will sell most rapidly, and without regard for the needs of industry as a whole. Though there are very able promoters whose efforts are valuable to the market, the ease with which they may operate and then "slide out from

under" makes their profession an ideal one for not overly honest men of an adventuresome nature.

On the other hand, the issue house has a more stable position. Its permanence allows a continuity of policy and enables it to win a reputation for sound banking. It is able to employ a regular staff of investigators to examine would-be borrowers, and on the whole is in a more favorable position than the ordinary promoter. However, since the issue house is unlikely to undertake the issues of any borrowers but governments, municipalities, or well-established businesses, the new business is driven into the hands of the promoter or it must essay a public issue by itself. As we shall see later, the brokers, or actual retailers of securities, prefer to handle the securities from a responsible issue house of high reputation, for in that way they will not be likely to injure their standing among their clients. Now, if these chief issue houses are closed to the new business, it has no other choice and must get the less efficient service of the smaller means of the promoter. The promoter then has the choice among the new and smaller companies of what shall be presented to the public, and as described above, he will be moved not by the probable profitableness of the venture or its social good, but purely by the direction the public is taking when "on the feed." The promoter is anything but scientific in his choice of promotions. Since the big issue house will not bother with small undertakings, the ordinary companies must scrape along as best

they may. Lawson states that there is a "wide-felt need for some kind of bank or trust company which could *guarantee* to the investing public administrative, financial, and technical skill in management of new ventures."¹ This would be a good deal of a development for England and distinctly contrary to most of her present policies, but it would solve the financing problem for a good many medium-sized companies. It is especially difficult for a little-known firm to get capital. A small business producing some well-known article might get its issue successfully before the public, but a company that is both small and unknown is lost.

BORROWING WITHOUT THE AID OF AN ISSUE HOUSE

Those going to the market for capital without the services of an issue house or a promoter are either very well known or very poorly known organizations. The large, well-known firms go alone because they don't need help, and the poor ones go alone because they can't get help. Issue houses are made use of for four reasons. First, they know the market and can advise the best bait—that is, the best type of security—to catch the investor at the moment. They also know the best time to issue, avoiding periods when taxes or other payments are due. Secondly, the issue house will buy the issue outright, supplying the borrower with his funds at once. This is an important point, for a borrower rarely borrows unless he

¹ Quoted in *Financing of Industry and Trade*, F. S. Foxwell, p. 130.

really needs funds and, if he has to wait until investors get around to sending him their money, he may have a slow time. But all worry on his part is over when he sells an issue of securities to a reliable issue house. They have promised to pay him in full whether they sell out or not, and often the dead certainty of having the money guaranteed is worth paying the issue house's charge. Thirdly, and less important, there is considerable clerical work and advertising to be done, preparing the prospectus, and so forth, which the issue house is able to do with all the advantage of experience behind it. Lastly, each issue house of standing has a good reputation among the brokers, who will more gladly recommend a security issued by a strong house than one from a company direct. The last question will be considered more thoroughly a little later.

Only if a borrower feels that he can do without these services, or find substitutes for them, and can do so at less cost than the services of an issue house will command, will he undertake issue without help. We may consider a company that has decided to issue its own securities. What steps will it take? For information as to the state of the market the company will go to its broker. He knows well what shape the loan should take and will advise accordingly. But the second step, that of securing the money, must depend upon the rapidity with which the public interests itself in the issue. Of course, the underwriting of the issue may be arranged, and ordinarily will be

arranged, but here you have underwriting in its purest form—that is, a strict insurance of sale—and the company will not get its money from the underwriters, if the issue is not a “go,” until the last day for attempted sales has elapsed. Whether a company will have its issue underwritten or not depends on the same factors mentioned before in this connection. The decision will generally hinge upon the prominence of the borrower and the underwriting rate. The third point, the matter of clerical work, is more easily handled, the services of a bank almost always being secured to perform this function. The bank will also see to the preparation of the prospectus, make up mailing lists, accept subscriptions for shares, pay dividends, and, in fact, will perform a hundred and one little acts of varying importance. The bank's name will appear upon the prospectus and will give a hint as to the character of the borrowing concern, because a good bank will not lend its name to poor companies.

But when it comes to the reputation that an issue house possesses among brokers, there is no substitute and the borrower can depend only upon his own name and to some extent on the name of the banker who graces his prospectus.

The company issuing by itself will also lack the organizing of the market when the issue is made. When an issue house brings out a security it arranges what quotations the jobbers will make on it. In fact, firms of jobbers will often apply for a block of the shares in anticipation of a demand for it. The brok-

ers and jobbers will also get together, under the guidance of the issue house, and decide whether the stock shall be sold at a premium or a discount and by how much. All this the company issuing alone will lack.

Nevertheless, a large number of companies do their own financing each year in this way and are successful. Issues of this kind are more easily floated for the purpose of securing additional capital than for obtaining the original funds for starting.

This is because the name of the company seeking additional capital is comparatively well known to the market place and possibly to the prospective investor. The securities of an old established concern have been traded in upon the Exchange and have been quoted in the Official List of the Exchange. Brokers also have handled their debentures or stock for clients and have some idea of the degree of success which the company has obtained in business. The broker may have seen its balance sheets or read reports of its stockholders' meetings, its earnings, type of business, the size and security of its markets, the number and strength of its competitors, and, in fact, a great mass of miscellaneous information and gossip regarding the general standing and future prospects of the company in its branch of industry.

Again, a company which has borrowed from the public in the past has a long list of its present stockholders who may be assumed to possess some wealth and a considerable interest in the development of their company. These old investors constitute a very valua-

able source of additional capital which may be tapped, and if the company has done well in the past, it may reasonably expect hearty support from these people and good participation in its new security issue. Sometimes old companies seeking additional funds will limit their offerings of securities to their old subscribers, because they are assured of their strong support and because they prefer to have their issues held in the hands of individuals who will be unlikely to let the securities drift away from them into the hands of miscellaneous bankers or brokers who might make them the object of speculation and manipulation on the Exchange.

Therefore, the company that has borrowed publicly in the past has a considerable advantage over the new company when it sets out to secure funds. It is known to brokers and investors who follow the fortunes of companies listed on the Exchange, it is known to the general public who may purchase its products or utilize its services, and it possesses a sturdy body of stockholders whose interest in the company's progress may be counted upon to elicit support.

The costs involved when the borrower operates for himself are high. Brokers and solicitors usually receive £1,000 apiece for their services, and the preparation and distribution of the prospectus is expensive. The organization of good intermediary investment banks to take care of the smaller companies would be a great boon to them and would take a heavy burden from their shoulders.

When a government or large company wishes to secure a loan, it will go to London to an issue house. Colonial governments usually go to Nivison's, while Rothschild, Schroeder, Seligman, Speyer, and Koenig Brothers are among the other important houses. Before the war there was not a great deal of competition for government issues between these houses, because it was felt that each had a right to its own clients just as a doctor expects that no other physician will visit his patients unless requested. However, since the war competition has developed.

COMPETITION AMONG ISSUE HOUSES

Now most of the issue houses will take any kind of business that comes to them; that is, they will help to finance any business that appears to be sound and the securities of which promise to be marketable with reasonable ease and satisfactory profit. The competition for the opportunity to serve borrowing companies is becoming increasingly keen, but the houses will respect the prior claim of another house to the business of a particular borrower, one who has been taken care of before by that house. In other words, though there is strong competition to secure funds for companies coming to the market for the first time, after the company has decided to accept the offer of one of the houses and has made an agreement with it, the other houses will generally hold off in all future times when that company may need assistance again. In order to bind more firmly the borrower to the

issue house, the latter will often request that it be allowed to be represented upon the company's board of directors by one of its own men. In some cases, where the company is sorely in need of funds and does not seem to be in the hands of unusually able managers, this request of the issue house may amount to insistence in order that the latter may more closely observe the condition and progress of the borrowing firm. Borrowers who are in a strong position in their trade can very nearly dictate their own terms to the issue house, both as regards the price which they are to receive for their securities and the extent to which the representatives of the issue house may take a hand in their affairs. It is coming to be believed generally, however, that it is to the distinct advantage of any company to have upon its board of directors one or more men who are equipped by long experience with financial affairs to advise their colleagues as to the state of the money market and the general situation of business as a whole. This subject has been considered at greater length elsewhere.

In order to secure the lower rates resulting from competition, a strong borrower also may break away from a single issue house which has served it in the past and open relations with one or more other houses. A company doing this, however, takes considerable risk, for when it breaks its bonds with an issue house, it releases that house from any responsibility to it in the future. This may have serious consequences, for one of the greatest advantages that American and

German railroads and industrials have so far possessed is the support and cooperation which their investment houses have extended to them in both good and bad times. English companies generally get little enough attention from their banks, and it is unwise for them to "kick over the traces" in such a way as to make a ready response to their needs doubtful in future periods of business depression.

The issue houses realize that too severe competition will result only in cutting the margin of profit to so low a figure that there would be little encouragement to lending to borrowers. For that reason, they adhere quite strictly, whenever possible, to the policy of allowing each other to take care of their own "children," when it has once been decided to what issue house each "child" belongs.

The English houses consider it less necessary than do the American houses to divide up the participation in an issue of a company among several houses. One issue house is more likely to handle it alone. There are several reasons for this. In the first place, the size of the companies coming to the issue houses in London is small compared to the very large combines that appeal for money in America. The British companies in a single industry may have a capitalization, taken all together, as large as the capitalization in the same industry in the United States, but in England the individual units will be smaller and will not require as large loans at one time as do the American companies. So one issue house is very often able to handle

alone a single issue and need not call for financial assistance from other houses.

Another reason for the ability of single houses to handle loans by themselves lies in the fact that in England a period of about two weeks elapses between the time the issue house puts an issue of securities upon the market and the time at which it is required to make payment to the borrowing company. Thus, the issue house has between 10 and 15 days during which it may receive money from subscribers to stock in the issue being made. In this period a large part, if not all, of the money which is due the borrowing company is collected. To the investment houses of the United States this is an entirely new idea, for in this country a company would not deliver its securities to be sold to the banker until it had received payment in full for them. The result in America is to force the investment bankers to join together, in order to make up the large sums of money required and also to make it necessary for them to borrow funds from the commercial banks to enable them to pay the borrowing company for its securities. The investment bankers deposit some of these securities with the commercial banker as security for the loan. As the shares or bonds are sold to the public, the investment banker withdraws them from the commercial banker under a special agreement used in such transactions and pays off the loan to the bank with the proceeds of the sale of the securities withdrawn.

In England, on the other hand, the borrowing com-

pany is more lenient with the issue house. The latter not only is allowed two weeks' grace before it need pay for the stock given to it, but it also has the use of the funds of subscribers from the time they come in until the day upon which payment for the issue must be made to the company. This use of the money of subscribers for a fortnight is valued by the issue house and it finds it can make very profitable use of it. Of course, when an issue will not sell, the issue house must pay the full amount due the company at the conclusion of this period of grace. If the issue has not been underwritten, a very serious situation exists and the issue house must find funds somewhere in London to make the payment to the company and to carry its own business along until it can liquidate the securities which so burden it. The issue house also makes use of other sources of money, besides that secured directly from subscribers, to enable it to pay the company for its shares. The issue house accepts ordinary deposits from the public and makes this a quite important part of its business. Regular deposit facilities are provided and large houses have considerable sums in their deposit accounts. Of course, these deposits are not checking accounts, and the house expects that they will be left with it for some little time. A rate of interest is paid upon the deposits. Again, an issue house may borrow from savings banks or similar institutions, in order to swell the volume of its available cash. The result of all this is to put the issue house at all times in a supply of money which

it must utilize or else keep in its vaults while it is paying interest for it. From this situation has developed the practice of the issue houses of buying and holding short-time bills, which are purchased from the bill-brokers of the city. Only those bills which are readily disposed of at no depreciation in price are considered, because the issue house wishes to be prepared at all times to take advantage of an opportunity to serve a nation or company seeking capital for long-time use. However, this shows the extremely varied interests of the issue house. Its own capital, that borrowed from savings banks—not from commercial banks as in America—and the funds from subscribers held for a two weeks' period before being delivered to the borrowing company, all constitute a very respectable sum of money upon which a good profit may be made in the bill market. This is particularly true of the money received from subscribers, for the issue house pays no interest for that and so has the use of it gratis for two weeks.

The third reason which renders it unnecessary for more than one issue house to join in bringing out an issue of securities is mainly the result of custom. In America an investment house that secures an issue will ask a few other houses to unite with it in the act and in this way will share its business with them; that is, the other houses will be given a chance to make a little money out of the proposition as a matter of courtesy. In return for this, all the houses expect reciprocity; when another one of them gets an issue,

the business is divided up so that every one will have something to sell at all times. Of course, the number of houses over which this is spread is limited to a few which are accustomed to work together in this method, and certain groups come to be identified in this way as houses that will stand together on both large and small issues.

In England this custom has not developed. An issue house securing an issue feels under no obligation to share it with other houses and will rarely do so, unless the amount is so large as to preclude its being handled by the house alone. In that case other houses will be called upon and asked to take a participation in the issue and certain houses will, of course, think of calling upon other houses in which they have a particular interest of some kind, but the obligation to share for the sake of reciprocity is not generally present.

Also, as will be explained more fully later, every issue house has access to all brokers, who are the final distributers of the securities to the public, and thus no English house need feel it advantageous to go to other issue houses to secure wider distribution. Since money is the single object of the issue house in such a case, it can go for help to any type of institution, insurance companies, investment trusts, or what not. Not so in America—here every investment house has a different group of correspondents, spread throughout the country and closely identified with the large house in matters of distribution of large secur-

ity issues. Each member of this group, and each member of every group, has its own list of customers among the investing public. Thus, for an American house to secure the widest distribution it must call in several large houses with long strings of correspondents in every part of the country, and the correspondents in turn will distribute directly to the public and also down through a string of smaller correspondents of their own until every investor in the country has been given an opportunity to buy. But, as said before, this is unnecessary in England, where every issue house has direct contact with all brokers, who in turn reach the investors.

When the borrowing government or company has applied for a loan to an issue house, the latter will examine the affairs of the applicant before quoting a price at which it will take over the entire issue, and, if the price is satisfactory, it will make arrangements to pay it to the borrower upon a certain day.

THE WORK OF ISSUE

The investigation of the issue house is very searching, and the houses most anxious to preserve their reputations for bringing out only good securities have excellent staffs of accountants and engineers, who examine every project brought to the issue house and submit a report as to the advisability of undertaking the issue. However, this analysis is fitted only to large and well-known projects and it has not been applied to home industrials, for many local ventures,

which often seem to be quite promising, are turned down without examination. The judgment of the issue house is also employed to decide what form the securities shall take. They know the market well and, perhaps with the advice of some of the brokers, will adopt the type of bond or share that will appeal to the public taste at the moment and will also be least expensive to the borrower. The issue house now has a large amount of unsold securities on hand and has promised to pay for them on a definite date. It must sell these securities at a profit as soon as possible. First of all, it will probably underwrite the amount of the issue. In other words, it will insure itself by paying to certain groups and individuals a sum of money, usually 1% to 3% of the amount underwritten, in return for which the underwriters will agree to buy all securities unsold by a certain date and up to the amount for which they have underwritten. The underwriters may be other issue houses, brokers, banks, insurance companies, investment trusts, and some individuals. Originally, underwriting was purely an insurance undertaken by the issuing house to protect itself in case the issue did not "take." Very often the underwriters had no desire to have the securities which they had underwritten, and might be greatly inconvenienced if the issue failed and they had to take some shares. The 1% to 3% fee attracted them, however, and when they were approached by a powerful house they always took as much underwriting as was offered them, because they

knew that if they refused once they would be very unlikely to have a second call.

Subunderwriting contracts are utilized to discount large blocks of securities to important individual investors at a slightly reduced cost. The subunderwriting rate is generally 3% to 5%, less the percentage of the original underwriting rate. Not only large individual investors, but also investment trusts and insurance companies, are granted this reduction. The issue house is glad to concede a price reduction to institutions of the type last mentioned, because it may be reasonably certain that the securities have been purchased for permanent investment and not for immediate resale. Resale is unpopular with issue houses, because if large quantities are released in the market in this way there is very likely to be a break in the price of the bond or share and the work of disposing of the remaining securities is made difficult except at a reduction in the margin of profit to the issue house. In addition, those investors who have bought at the higher price are disgruntled to see a decline in the price of securities within a few days of their purchase.

The underwriting fee, of course, varies with the risks assumed. It would be almost impossible to have underwritten an extremely speculative and little known South American bond. Sometimes the fee amounts to as much as 50%, but this is only in the case of highly speculative issues, usually in the hands of promoters who figure that their best chance of get-

ting any money at all is to underwrite at any cost and be satisfied with what they can get out of it.

On the other hand, some very well known securities are not underwritten, because the issuing house feels that it is taking no risk in handling this type of bonds or shares and might just as well economize and not spend anything on the underwriting fee. Of course, the advantage of underwriting lies in the fact that no matter how badly the issue goes, the issue house has its money to pay the borrower upon the appointed day. However, a new conception of underwriting has developed and instead of its being a purely precautionary measure, it has become a method of assigning blocks of securities to the underwriters who intend to make a profit out of their resale. The underwriters are expected to take their stock outright. Insurance companies and investment trusts now also underwrite large parts of issue, occasionally all of an issue, in order to add to their holdings at lower than the market price. Still both methods of underwriting exist —some the pure insurance function, others the combination insurance and participation method.

THE PROSPECTUS

While the underwriting is going on, prospectuses are being printed. A prospectus includes the latest balance sheets of the borrower, certain data about his present and past condition, officers, use to which the money will be put, and so forth. The name of the broker or banker who will receive subscriptions

is also noted. This broker or banker receives a fee for allowing his name to be printed on the prospectus and one of the best guides to the soundness of an issue is the broker's name, for no good broker would allow his name to be used by a borrower of unsavory reputation. Enclosed with every prospectus is an application blank, on which the recipient of the prospectus may subscribe by filling it out and sending it to the banker or broker mentioned above.

The importance of the preparation of the prospectus cannot be overstated, as will be seen more clearly when the methods of distribution by the broker are considered. The broker makes very little sales effort and is generally content to let the prospective investor select his own investment, guided almost solely by the information printed upon the prospectus. In the United States the prospectus is used chiefly as a means to arouse the general interest of the investor or to remind him of facts brought out in a talk with a salesman. The salesman is the actual instrument for the disposal of securities in this country. That the bankers appreciate the extreme importance of the prospectus is evident from the great care which they bestow upon its preparation. The most attractive features of the proposition are carefully presented and many details are included. Almost all English books upon the principles of banking devote at least a chapter to this subject and describe various forms in which the prospectus may be presented.

Very strict laws rigidly define the material which

must and must not be included and every attempt is made to safeguard the unwary investor. The Companies (Consolidation) Act of 1908 forbids a company to make an appeal for capital to the public unless the company either issues a prospectus, or a "statement in lieu of a prospectus," which must be signed by all the directors of the new company. The law clearly offers remedy to those harmed by misrepresentation.

The subsequent work of the issue house is similar to that required for the company or government which issues its securities without aid. The relations with the broker are, of course, very important and will be discussed later.

The issuing broker, another member of the organization, does not buy an issue outright as do the regular issue houses, but simply organizes the underwriting. He will secure institutions and brokers to underwrite the issue for the regular 1% to 3% fee and then for his services in securing underwriters he will receive $\frac{1}{2}$ of 1%, called an "overriding" commission, plus the regular underwriting fee on any securities he may have underwritten himself. Of course, this is not his only function, as he may buy and sell securities like any other outside broker; but this is his contribution to the work of issue.

THE BRITISH STOCK-BROKERS' TRUST

The most recent addition to the issuing organizations is the British Stock-Brokers' Trust, formed in

1919. The trust was organized by and composed of most of the stock-brokers in England, and their purpose was to do away with the issue house and to handle the whole business by themselves. They planned to buy issues outright from the borrower and do the work of the regular issue house and other middlemen. They felt that the brokers were the real distributers and that this gigantic issue house operated by them could perform all the necessary functions. At first the trust did very well and got a good deal of business. However, a short time ago they learned that Nivison's was preparing to handle one of the large colonial loans, as it always did. They determined to get the business away and went to the colony about it. The latter were at first unwilling, but as the trust offered them a higher price for the issue than did Nivison, they saw no reason why they should not give the business to the trust. However, when Nivison heard that he had lost the issue to the trust he immediately wrote to all the brokers in England warning them if they touched a share of the colonial issue, he would never fill one of their applications to him on behalf of their clients to another issue! This settled the matter and none of the brokers would take part in the distribution of the colonial securities and the trust stockholders found themselves "hung up" with the large issue which they had contracted for. The only thing they could do was to hand it over to Nivison with as good grace as possible and accept the small loss. Since then the trust

has done some business, but it is not powerful and does not figure heavily in the market. It is interesting to note that Nivison's is about the only issue house that has succeeded in holding its colonial business since the war. Most of the issue houses have lost some of their business, due to the competition which has developed.

Since the war one or two of the very large joint stock banks have brought out issues of home industrials, but this is decidedly outside their field of short-time loans and it is unlikely that the venture will be continued. The joint stock banks have also occasionally given their guarantee to the security of individual borrowings of companies from their rather personal acquaintances and so have saved the company from the necessity of making an issue of securities which would inform the public that the company was borrowing.

But, "in England only the better classes of securities are marketed by specialized institutions."¹ Governments, municipalities, and the largest transport companies only were handled by the issue houses up to a few years ago, and even now they furnish the principal business. The English industries have been considered too small and it has been maintained that industrials are unpopular with the British public. However, there is a growing appreciation of the profits to be derived from these industrials and within the past 15 years they have gained in popularity. But,

¹ Lavington, *English Capital Market*, p. 183.

as stated above, the feeling that it is a sign of a weakness for a company to go to market for capital still seems to prevail to some extent. Sixty per cent of the British industrials are not handled through the issue houses, but conduct their issues themselves in their appeals to the private investor.

VI

AVENUES OF INVESTMENT

The small investor. The broker. The branch bank. The broker as an adviser. Other advisory services. The work of distribution. Importance of the broker. Graphic illustrations of the organization of the English investment market.

THE surplus capital of England is raked from its holders in a very efficient manner and finds its way quickly into loans of various kinds. It is extraordinary to observe how thoroughly the savings are drawn out and utilized in industry and trade. Savers will keep small deposits in savings banks, perhaps the Post-Office Savings Bank. When a hundred pounds or so have been accumulated, the owner will generally go to his broker in order to invest his money. If he does not go to a broker, he can send his money direct to a company whose prospectus he sees advertised in the newspapers. But the more common way is for him to take his money and go either to his local broker or manager of the local branch bank.

THE BROKER

The broker is an individual who is more or less a public servant. He is really an agent and his business is to buy or sell securities at the request of his clients. There are many of them in London, of

course, but there are also great numbers of them throughout England in every town of any size at all. He will have a small office where he can be consulted by people desiring to deal in securities. Every Englishman has his broker just as he has his lawyer or doctor, and when he has any stock exchange transaction to make he does it through this man—that is, unless he goes to the branch bank. The British Government, for example, has its own brokers, Mullens, Marshall and Company, who transact all Government business. There are both "inside" and "outside" brokers. The "inside" broker is a member of the Exchange and so is the actual person who does the business with the jobber. The "outside" jobber, on the other hand, is not a member of the Exchange and if he wants to operate there he must do so through an "inside" broker. The "inside" broker acts more truly as a broker; that is, he buys and sells chiefly as he is told, the brokers who are not members doing more in the advisory line. All of the brokers in the country and cities about London have correspondent "inside" brokers in the City to whom they send in daily the orders to buy or sell received from their clients.

A man rarely changes his broker and will always keep in touch with him so as to be acquainted with the state of the market and the new issues which are being developed. The broker collects and gathers together the savings of the public and turns them into the issue house, or promoter, or company issuing itself in London.

The advisory functions of the broker are developing rapidly. Time was when the broker felt it his duty to buy and sell only upon his customer's orders, but with the great increase in the number of loans and the types of securities it is so difficult for the private investor to judge their soundness that the broker has become a distinct adviser in the choice of investments. In the case of old, well-seasoned securities which have been on the market for some time, he is well qualified by observation to judge of their merits. With new issues the broker is more likely to depend for his information upon the standing of the issuer, and that is why he prefers the issues of issue houses to those of promoters or companies themselves. But the extent to which brokers will advise varies greatly with the broker and probably no English broker goes into the history and condition of the companies in whose securities his client asks him to deal, as do the investment bankers of the United States. The brokers in London send out bits of information daily to their country correspondents and the issue houses do the same, in order to keep up connections and to keep the investor in the country supplied with information.

THE BRANCH BANK

The branch banks, on the other hand, are the local representatives of the great English banks which do a commercial business. These are the banks of the type of Lloyd's, Barclays, or the London Joint City and Midland. Each of these banks has several hun-

dred branches, one in every English town, and these offices serve as places where a man with a little money may go for help when investing. The manager of the branch bank will discuss with him the various securities to be had and, after a decision has been reached, will take the investor's money and send it with his order for the agreed bonds or stocks to the "inside" broker who transacts that kind of business for that particular bank. Here the broker is exercising his pure dealing function and is not advising the purchaser of the securities. For a long time the broker felt that his only service to his client was to get as good a bargain for him as possible from the jobber in the purchase or sale of securities, but greater competition and growth of the market have led him into the advisory field. There was a time when it was said that the broker knew little of what he was handling, but this attitude is rapidly passing away.

The branch bank manager, however, has not the time to advise thoroughly all the clients of the bank and it is unfortunate that the broker is not used in place of the branch bank for security dealings. The close contact of the broker with the market gives him a great advantage over the banker as an adviser and he could be of very great service to the public. But the greater accessibility of the branch bank has increased its popularity with investors and they are flocking there in steadily mounting numbers. If the brokers would advertise a little and open up a little

more to the public they would be well rewarded, for the business has to go through them anyway and they might just as well get the full commission for handling the complete transaction instead of dividing the commission half and half with the banker as they now do. The growth of the banks' business of this kind has encouraged them to clear the orders for securities among themselves. The *Statist*¹ in a recent number expresses the view that a growth of this clearing might weaken the regular stock market by lowering its number of transactions and so narrowing its field. Because of their fear that the branch managers will assume too much responsibility when giving advice, many of the bank heads require that the managers shall not advise individuals but shall apply to the main office for a suitable list of investments, which list is in turn handed over to the investor. Perhaps this decrease in service supplied by the banks will turn the investor toward the broker.

THE BROKER AS AN ADVISER

The brokers make their profit on the commission they get on their sales of securities and do not expect to make money by buying them at one price and selling them at another. It is a pure question of acting as an agency, and the best brokers are those who, in addition, are qualified to advise their clients as to the relative merits of the securities to be had. There are some exceptions, and recently some of the issue

¹ Issue of March 3, 1923.

houses have expected the larger brokers to take up with their own capital a part of an issue and to hold it until some of the clients of the broker could be induced to purchase the block. But this is decidedly the exception and not the rule, and the broker is generally a free lance. In some instances a highly desirable issue may be on the point of coming out, and in such a situation a broker may desire the issue house to reserve for him a number of the securities, in order that he may fill all the orders of his clients which he feels sure will be attracted by the particular issue. This is a little different from the preceding case, when the broker was asked to help the issue house out, and may be considered more typical.

The "inside" brokers are, on the whole, the most reliable, because before they are admitted to the Stock Exchange their records and methods are given a fairly close scrutiny. But there are also many thoroughly dependable "outside" brokers, the only difficulty with "outside" brokers being that the uninitiated investor has no method of distinguishing the good from the bad.

The "inside" broker is limited in his publicity because he can send prospectuses and announcements of issues and of good "buys" in securities only to his regular customers. The "outside" broker, on the other hand, has the advantage of being permitted to circularize anyone he may desire.

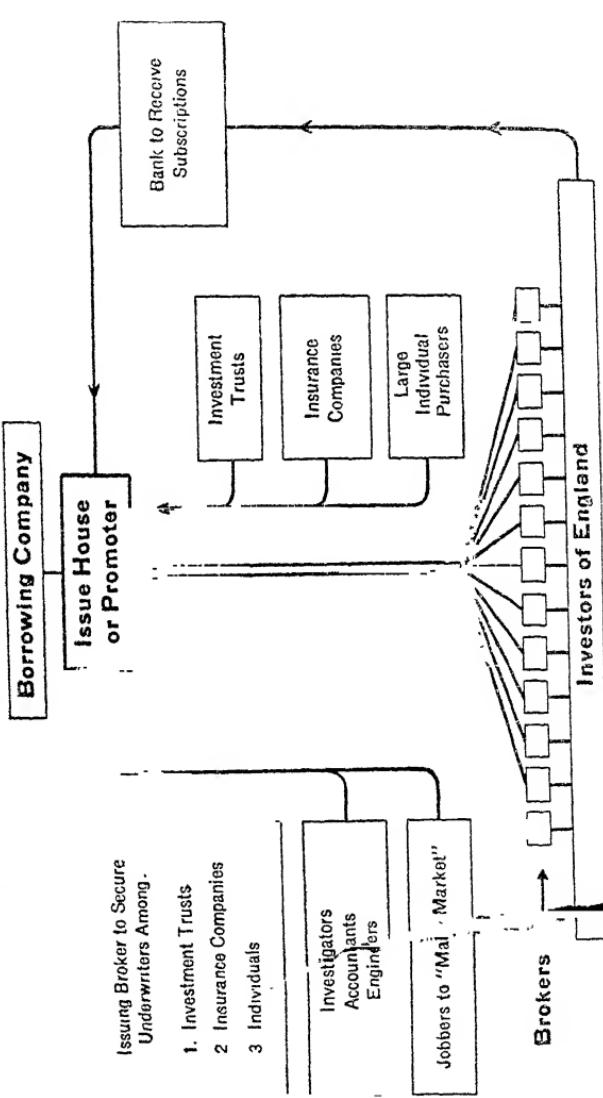
To help the investor to choose we also find many financial papers and magazines, and every daily news-

paper has its "City" column or page. In recent years the tendency of these papers and articles has been to criticize the various issues and securities coming to their attention, instead of simply stating the bare figures and facts about them. This is a perfectly healthy step and one to be encouraged, because the entire financial organization should realize that it has a certain guardianship over the savings of many people and that it should make use of its "inside" information and experience for the benefit of the public who have their own businesses to attend to and have neither the time nor the opportunity to get full and perfect information. The Investment Registry, Limited, was one of the first companies to emphasize its advisory services. It offered to make up investment lists and to change old ones, and, in addition, did a regular stock-broker's business. Its profits are made by charging people who come to them for advice a small percentage of the total investment list submitted for inspection. This company was formed in 1880 and is still operating.

THE WORK OF DISTRIBUTION

It is necessary next to examine the relation which the work of the broker bears to the issue of securities. When an issue is made, whether by an issue house, a promoter, or the company itself, a prospectus is printed. The issuers of the securities will send these prospectuses to the brokers throughout the country, and particularly to those with whom they have dealt

Organization of the English Investment Market



before. The better issue houses will have a larger following of brokers than have the others, because the brokers will know that certain houses bring out the best securities. At the same time the prospectuses are sent out, they will also be printed in some of the financial papers and on the financial pages of ordinary newspapers. Some care must be taken to choose the proper advertising mediums with relation to the kind of security that is being offered. Conservative issues manifestly would not appeal to the readers of a rather light and sensational paper. A speculative issue might more properly be presented there.

It is then up to the broker and the public. If the investors realize that the issue is a good one and not to be missed, they will either go to their brokers and put in orders for shares or they will apply directly to the agent appointed by the issuer to receive subscriptions. If the investor is particularly anxious to secure all of the securities for which it is applying, he may avoid having his application cut down by sending his request for shares directly to the issue house or the broker whom the latter has designated for that purpose. In this way he is less likely to have his order reduced than if he sent his order to his own broker, who would then send in to the issue house the combined orders of all his clients. Because issue houses like to have their securities held in small hands, they do not cut down small applications. An order from a broker on behalf of his clients may be reduced, but if the broker's clients send in their orders individ-

ually, they are likely to get the full quota applied for.

The broker, when he receives the prospectuses from the issuer, will place a stamp bearing his name upon each one. Then he distributes the prospectuses among his clients, who may send in their applications to the issuer's agent themselves. The broker's stamp on the application will inform the issuer by what broker the business was secured, and the issuer will then credit that broker with a sum for his commission. So it may be seen that the subscriptions come direct to the issuer of the securities and that the service of each broker is to bring the issue to the attention of his particular group of clients. Therein lies the value of the broker to the issuer—each one has a special audience of investors to whom he communicates the news of an issue. To repeat, the broker is in rather a public position and is used by all issuers. They send him their prospectuses and he simply stamps his name on them and sends them out again to his clients.

The broker informs his clients of a new issue by telephone or by letter, but never sends out a salesman as is the custom in America. His position is an individual and a confidential one; he is not a salesman and often hesitates even to recommend; he merely presents several prospectuses of new companies or balance sheets of old ones and puts the decision up to his client. Sometimes his client, having known the broker a good part of his life and feeling entire trust in him, will request him to make the selection. In

such a case the broker will be guided chiefly by the reputation of the issue house involved and possibly by the reputation of the broker whose name appears on the prospectus. The tendency of the broker in recent years has been to become more familiar with the various companies and governments whose shares or bonds appear upon the exchange. The great number of borrowers in the present industrial organization and the many complex forms which securities take, have made it extremely difficult for the ordinary investor to make wise selections of securities.

In this connection the independent position of the broker is very important. He is under obligation to no issue house or to himself to dispose of a certain issue of securities. He has the entire range of bonds, debentures, and shares to select from in advising his client. Far different is the position of the American distributor of stocks and bonds. The latter, forced by the scarcity of capital relative to the mighty demands for it, is compelled to adopt the most aggressive methods to secure it. Both buying and distributing an issue of securities himself, the American investment banker is limited in his recommendations of investments to the public. In addition to this, it is customary for an American house to specialize in a form of security, as in bonds alone or in preferred stock. Again, the specialization may be in the type of the borrower—one house will handle government issues only, another only railroads, or public utilities. In this respect the English broker has a distinct ad-

vantage. He is entirely free to select whatever security of whatever company appears best suited to the requirements of his client. He may select shares which have been long quoted and with whose history he is familiar or he may turn to one of the new issues. The broker's interest in selling old as well as new securities has the beneficial effect of widening the London stock market. A very wide range of stocks is dealt in there, because investors are just as likely to place their money in old issues as in new ones.

The disinterestedness of the broker in what he recommends to his clients tends toward an impartial judgment on his part. He is driven by no necessity of "clearing his shelves" of securities for which he has paid and which he must liquidate in order to be solvent. The result seems to be sound, granting the broker is a good judge of investments. In this way every English investor can have at his call a person whose entire business is the inspection of securities. The broker rarely makes more profit on one security than on another—he is paid a straight brokerage of about three shillings per one pound share, or about $1\frac{1}{4}\%$ —and even if the profit varies slightly in some cases, the ethical standards of the broker's profession forbid him to let his judgment be influenced by such a consideration. This is a very advantageous situation. Issue houses and promoters are less likely to bring out economically unsound issues when they know that the brokers are coldly eyeing the proposition. The brokers exercise in this way a profound in-

fluence upon the direction which industrial development will take. As the brokers become more definitely investment advisers, this pressure upon issue houses and promoters will grow and should result in benefits to the entire community, from the borrowing company to the smallest investor.

The English borrowers rely upon a general public issue and upon wide publicity for the prospectus to see their securities. They use the broker not to sell the issue for them, but chiefly to secure wider circulation and publicity for the prospectus, which will in this way be gotten before the public. The system is centralizing and the issuing houses or the borrowers themselves distribute the securities *directly* to the public. But the investors among the public are ferreted out and directed to the issuer by the broker.

As said above, the stronger issue houses find that the brokers are willing to handle their securities in preference to the issues of promoters and companies themselves. This is because the broker feels that a good issue house will not handle an issue that is not perfectly sound. In this way a broker can pick fairly good securities by noting who is issuing them and so will preserve his reputation as a careful adviser.

The great importance of the broker must not be lost sight of. It is he who makes the market for the new issues. He may not make it by violent agitation and solicitation, but by his hold on his clients he is able to spread the information and means of subscribing to an issue among a very fair number of peo-

ple. He is the real distributor and his own belief in that fact is shown by his attempt to do away with the issue house and the promoter by the formation of the British Stock-Brokers' Trust mentioned above. The broker is wrong in thinking that he can do away with the issue house, because it exercises important functions; but his part in finding the final resting-place for securities is probably the most necessary.

VII

THE INVESTMENT TRUST

Functions of the investment trust. Average earnings per year of 45 trusts between 1910-1920. List of 11 typical investment trusts with their capitalization in 1915. The fundamental purpose of investment trusts. The investment trust and the small investor. History of investment trusts. The Companies Act of 1862 a stimulant to investment trusts.

THE investment trust is another important factor in the English investment market. The investment trust is set aside and given special treatment here, because it originated in Great Britain and was one of the principal methods some years ago by which English capital was directed abroad and utilized so beneficially in the development of new countries.

The investment trust is a company, usually in corporate form, organized to use its funds in long-time loans under the guidance of a group of directors. In its commonest form the trust issues its obligations and with the proceeds invests in other companies, usually of a diversified nature. However, a trust is sometimes organized to hold the stock of one industry only, and then it approaches somewhat the American "holding" company, or it may invest in the securities of a special geographical section; as in the East, Africa, or any other land.

The trust is formed like any other company and its securities are issued and held by the public. The

shares are also entered on the Stock Exchange and are dealt in like those of any other joint stock company.

Trusts take the savings of the public, when the latter buys the shares of the company, just like a bank; but instead of employing the money in short-time loans, it is poured into the bonds or stocks issued by governments and businesses.

The names of the investment trusts vary, such as Financial Trust; or Financial, Land, and Investment Company, but they are all formed with practically the same end in view. Lavington¹ finds a slight difference between the two types just mentioned. He states that the latter are perhaps a little more speculative and loan for shorter periods, but he adds that for practical purposes there is no genuine line of demarcation and that they may be classed together. There are several hundred of the trusts in London controlling a total capital of about 350 million pounds. W. E. Lagerquist gives the following figures for the earnings of 45 trusts between 1910-1920:²

AVERAGE EARNINGS PER YEAR

| | |
|-------------------------|--------------|
| 16 trusts | 6-10% |
| 11 trusts | 11-25% |
| 12 trusts | 5- 6% |
| 6 trusts | less than 5% |
| Average 45 trusts | 7.9% |

For example, the British Investment Trust and the Metropolitan Trust, two of the largest, have averaged

¹ Lavington, *English Capital Market*.

² Lagerquist, W. E., *Foreign Investment Trusts*.

13% and 12%, respectively, in that number of years. The latter company has, according to the 1919 report, investments in 230 companies. Of these, 50% are in railroad and street-car lines and an unusually large number (20%) are in government bonds, on account of the war. One-third of the capital is invested in the United States and one-quarter, again an unusual amount due to the war, in Great Britain. The Investment Trust Company, Limited, London, has 315 different investments (1917) and the Second Edinburgh Investment Trust has 235 (1917). The largest company is not capitalized for more than six or seven million pounds and many for much less. These companies all hold foreign-government issues, municipal bonds, preferred and common shares in railroads, public utilities, banking and other investment trust companies, and commercial and industrial joint stock companies of many countries. The number of different companies in which a trust will hold investments varies between 200 and 500, but generally averages about three hundred.

When forming the trust, deferred and preferred stock is issued in a ratio of about 2:1, the former at a rate of about 5% or 6% and the latter at about 5%. Below is a list of 11 typical investment trusts with their capitalization (share and debenture) in 1915. The names are interesting and give a clue to the interests of the companies as well as to their great variety.

Most trusts have restrictions upon the amount of the capitalization that may be invested in any one

| Investment Trust | Capitalization |
|-------------------------------|----------------|
| British | £5,238,787 |
| Foreign and Colonial | 3,161,727 |
| Mercantile | 6,412,297 |
| River Plate | 961,457 |
| Scottish-American | 4,598,328 |
| United States Debenture | 2,010,791 |
| Government Stocks | 1,920,488 |
| Guardian | 1,102,143 |
| International | 1,705,581 |
| Omnium | 1,637,138 |
| Railway Share | 1,108,766 |

company. Except for companies in Great Britain, one-twentieth is the average allowed, but the extremes run to one-third and one-thirtieth.

The investment trust is guided by a board of directors of half a dozen men and upon them rests the entire responsibility for the success of the company, for they must decide what securities their company will hold. The trust is different from the manufacturing or commercial company in that in the latter there is a large force engaged in the work of the company, but in the trust there is no staff except the directors and a few typists. There may be an analyzing and statistical department, but the number of employees is very small. There is no plant and a small office is all that is required. The directors must be men of long experience in the financial world and of unquestioned integrity, for, the assets being of liquid order, the opportunity for knavery is apparent. Their duty is to choose the securities which the com-

pany is to carry and to be ever on the alert for an opportunity to dispose of one stock for a more attractive one.

The investment trusts are in reality "expert investment agencies." Their fundamental purpose is to divide the risk among a great many securities and in a great many ways. By dividing the risk in this way they figure that no matter what is lost, there are very likely to be compensating gains. Risk is divided in several ways. Securities of a speculative sort yielding a high rate of interest, and which also have a possibility of appreciating in the value of the principal, are balanced by the bonds of the most conservative governments and municipalities.

The holdings among industries are diversified on the principle that if there is a slump in one branch of trade, others will hold steady. In times of war, marine and cable securities increase in value and so some of these are very often held. There is also some geographic distribution and this theory was very popular 15 years ago. The idea was that on the whole the production of the entire world increased yearly, so if holdings were scattered in 10 or more localities throughout the globe, even if business and trade in half the districts were bad, the return from the other half would more than compensate for the loss. In short, the scheme was not to carry all the eggs in one basket, but, on the contrary, to spread the risk in every direction and in every fashion.

It was recognized that the ordinary small investor

could not undertake this diversification for two reasons.

THE INVESTMENT TRUST AND THE SMALL INVESTOR

In the first place, the ordinary man has so little to invest that if he divided it up into several portions for different treatment, each part would be too insignificant to be of use. Then, again, the small investor has no means of securing adequate information to insure his properly placing his money. He has no way of judging the soundness of American railways or Bolivian mines or German industries. He must rely upon what he can pick from the press, or can secure from his broker, often little better informed than is he. For there are few men who keep in touch with the issues of the world and fewer still who are capable of choosing between them.

But when a small investor can buy the shares of an investment trust, most of his worries are over. His directors may rack their brains and scan the world for sound opportunities in which to place the aggregate savings of the small investors, but the individual need not fear if he has chosen the proper directors. Inaccessible places for the single investor were by this device opened up.

Besides the conveniences which it offers the small investor, the trust has advantages of its own. It may take up issues entire, or large portions of them, at the issuer's price, often well below the selling price to

the public. Issuers are always glad to have investment trusts hold their securities, because they realize they are more strongly held and there is less likelihood of their being dumped on the market. By its strength it is able to profit by the purchase of shares running low in the market through no fault of their own, but due to a general market weakness.

In fact, this point is so well recognized that investment trusts always try to start their careers, if possible, when securities are selling at a low rate and the market is dull.

Most of the trusts are formed to invest abroad, with a tendency toward rather speculative industrials and railroads. Their importance was tremendous in supplying capital to America, and many of the railroad shares are held by the trusts. They developed mines, roads, and manufactures with a generous hand. The field they found was large and the opportunities many. Some of the trusts were formed to undertake special projects, to deal in coffee or rubber plantations, in land mortgages, in cattle ranches, in any number of businesses.

Lavington also states that they were formed occasionally to market the issue of foreign-government bonds or of companies intending to operate in England. Powell says¹ they may accomplish salvage work by taking over insolvent undertakings of merit and develop them, and he calls this type of work "very important and characteristic." Sir Robert

¹ Powell, E. T., *Mechanism of the City*.

Giffen considers their operations, when buying up securities that are going below their intrinsic value, of great assistance in stabilizing the market.

They are able to encourage and carry on new and promising ventures in a way impossible but for their presence, and this in itself is a social advantage, for many new companies so aided would under ordinary circumstances find it impossible to secure capital except at very high cost and so their birth might never occur. If the trust finds that it has "fathered" a good thing, it may sell out to the public at a handsome profit.

The assets of the investment are constantly changing in value just as the stock market fluctuates. The securities of the trust itself move in company with other security prices, despite the fact that when the market drops, their earning power is increased.

The only undesirable feature about the trust is that it necessitates a transmission of the control over the individuals to a director who chooses in what direction the funds shall be placed. But when it is considered how impossible it would be for the ordinary investor to judge where the best opportunities are, it does not seem harmful that this control of the flow is held by strong hands. It is also true that the public can judge the condition of an investment trust more easily than that of any other company, for they have only to check up on the company's inventory of holdings the market value of each, and the company is so analyzed.

The investment trust arose in Scotland and England almost simultaneously, in an effort to find channels by which the surplus savings of the public could be guided from the somewhat satiated British capital market into foreign fields. Safety and knowledge were required and the trust seemed to be the solution.

HISTORY OF INVESTMENT TRUSTS

As early as 1825, a total of 28 investment companies were formed, but they were unsuccessful and were given up. R. Liefmann¹ says that the trusts in their present form were founded shortly after 1860. In 1868 the Foreign and Colonial Company issued its first stock with the object "to give to the small investor the same advantage as the large capitalist by spreading the risk and reserving extra dividends in a sinking fund to pay off the original capital."

The real stimulant to these trusts was the Companies Act of 1862 which brought to formation many joint stock companies of every description. It will be remembered that the limited liability clause was the important one in this connection. By 1870 the companies went into a great variety of securities and the guiding principles of diversification existing today began to grow. The higher interest rates abroad were appreciated and sought after. Viscount Goschen lays much of the blame for the rise of interest for money in the 60's in London to the vast expansion

¹ Liefmann, R., *Beteiligungs und Finanzierungsgesellschaften*, pp. 122-139

of joint stock companies and birth of financial companies capable of undertaking largest operations.¹ The companies swept the country of its savings in an unprecedented way and then spread it throughout the world. Up to then most financing on a large scale in foreign countries had been undertaken by private firms; now *companies* could reach for the high returns and there was a rush to organize the trusts. To quote Goschen again, "it should be remembered that until within a late period, a certain number of large firms alone were considered to have the secret of farming the commerce of distant lands with safety and advantage."¹ He terms the growth and extension abroad of these investment trusts "the English banking principle on a crusading tour through the world."²

The "boom" market of 1888 and 1889 caused a further increase in the number of trusts and an extension of the amount of speculative securities held, to the partial exclusion of government bonds. But many failures in the 90's drove them out of the ultra-speculative field, and since then they have directed themselves in a more conservative manner. The larger companies are found to be more profitable than the small ones and so there was a tendency to grow in size.

Within the past 10 years, however, the trusts have lost their foothold in the market, at least as dominating factors. The greater facilities for rapid com-

¹ Viscount Goschen, *Seven Per Cent*, p. 17.

² *Ibid.*

munication, the spread of general knowledge among the public, the many financial papers have all served to bring distant parts of the earth more closely to Britain and the investor is no longer entirely dependent upon the trust for guidance in selecting his securities. The advisory capacity of brokers is greater than it used to be and a very fair knowledge of conditions abroad is thus accessible to anyone. Yet the investment trusts are still strong and their utility is recognized in other places, for in 1917 the Congress of the United States passed the Edge Act making similar trusts legal in America. The purpose was perhaps fundamentally to provide machinery to reconstruct war-devastated Europe, but the form for investment trusts of every kind is now constructed and available.

The greatest service of the investment trusts has been the supplying of means by which small savings might be collected and condensed and sent to every part of the globe to develop new and backward regions and so render them productive.

VIII

SUMMARY

Development of investment banking. The Industrial Revolution. The Companies Act of 1862. English investment banking adverse to managing industries. The three avenues open to the borrowers—the issue house, the promoter, and a general appeal to the public. The broker, the mainstay of the system

INVESTMENT banking in England has been developed over a long period of years. The activities of stock-brokers depended upon the growth of companies whose shares might be distributed and upon the development of a market for the securities. The Industrial Revolution in the latter part of the eighteenth century developed the factory system and a resulting demand for funds to purchase equipment, and at the same time the new and more productive methods of applying labor caused to appear a group of capitalists whose profits and surplus funds constituted a real market for the investment banker's wares. Furthermore, the early development of England as a manufacturing nation caused her to be reasonably well equipped with machinery and plant at a somewhat earlier date than were other countries, so that her citizens could afford to participate in the development of these other states instead of requiring all their savings at home.

In 1862 the Companies Act established limited lia-

bility for the holders of securities and one of the greatest obstacles to investment for the small saver was swept aside. Investing was democratized as a result, and not only did a greatly increased portion of the public place its money in shares, but also there was less to fear from the securities bearing high interest and issued by foreign governments and companies.

English investment bankers consider it inconsistent with sound banking to enter into the managing of industries, and therefore limit their work to taking securities from the borrower and distributing them to the public. They prefer large and highly reputable governments and well-established companies for borrowers and are inclined to frown upon the ordinary industrial. How to induce the large banker to take an interest in new companies and projects is one of the present problems. Without the support of the important bankers the smaller companies are driven to less able promoters and houses.

The issue house, the promoter, and a general appeal to the public are the three avenues open to the borrower. The issue house is gaining in popularity, but 60% of the English industrials which borrow funds do so without the assistance of an intermediary. The issue house and promoter prepare the securities for sale and the brokers throughout the country find buyers for them. For this reason the broker is generally regarded as the mainstay of the system, as the one who actually secures the funds. However, the

broker looks for guidance to the issue house when he wishes to recommend investments to his clients.

The system is secure because the issue houses do not enter into the risks of the companies whose securities they bring out. However, this aloofness has some injurious effects, when it prevents new and potentially valuable companies from securing close attention and the sound advice that the investment bankers could give.

Perhaps a broadening of the feeling of responsibility on the part of the issue houses for the companies they handle and on the part of the brokers for the shares they sell their clients would be advantageous. Several steps in this direction seem to have been taken in recent years and it is very probable that a suitable balance will be reached.

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